S. HRG. 100-924

FCC PRICE CAP PROCEEDING

HEARING

BEFORE THE

SUBCOMMITTEE ON COMMUNICATIONS

OF THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

SECOND SESSION

ON

S. 2044

TO REQUIRE FURTHER REVIEW BY THE FEDERAL COMMUNICATIONS COMMISSION TO ENSURE THOROUGH DELIBERATION ON PROPOSED CHANGES IN THE METHOD OF REGULATION OF INTERSTATE BASIC SERVICE RATES

AUGUST 2, 1988

Printed for the use of the Committee on Commerce, Science, and Transportation

U.S. GOVERNMENT PRINTING OFFICE

90-108 O WASHINGTON : 1988

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

S261-15

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

ERNEST F. HOLLINGS, South Carolina, *Chairman*

DANIEL K. INOUYE, Hawaii
WENDELL H. FORD, Kentucky
DONALD W. RIEGLE, JR., Michigan
J. JAMES EXON, Nebraska
ALBERT GORE, JR., Tennessee
JOHN D. ROCKEFELLER IV, West Virginia
LLOYD BENTSEN, Texas
JOHN F. KERRY, Massachusetts
JOHN B. BREAUX, Louisiana
BROCK ADAMS, Washington
JOHN C. DANFORTH, Missouri
BOB PACKWOOD, Oregon
NANCY LANDON KASSEBAUM, Kansas
LARRY PRESSLER, South Dakota
TED STEVENS, Alaska
ROBERT W. KASTEN, JR., Wisconsin
PAUL S. TRIBLE, JR., Virginia
PETE WILSON, California
JOHN MCCAIN, Arizona

RALPH B. EVERETT, *Chief Counsel and Staff Director*
WALTER B. MCCORMICK, JR., *Minority Chief Counsel and Staff Director*

SUBCOMMITTEE ON COMMUNICATIONS

DANIEL K. INOUYE, Hawaii, *Chairman*

ERNEST F. HOLLINGS, South Carolina
WENDELL H. FORD, Kentucky
ALBERT GORE, JR., Tennessee
J. JAMES EXON, Nebraska
JOHN F. KERRY, Massachusetts
BOB PACKWOOD, Oregon
LARRY PRESSLER, South Dakota
TED STEVENS, Alaska
PETE WILSON, California
JOHN MCCAIN, Arizona

CONTENTS

	Page
Opening statement by Senator Inouye	1
Opening statement by Senator Pressler	2
Opening statement by the Chairman	5
Text of S. 2044	3

LIST OF WITNESSES

Bahr, Morton, president, Communications Workers of America, AFL-CIO	103
Prepared statement	105
Glynn, John M., People's Counsel for the State of Maryland	98
Prepared statement	99
Hasselwander, Alan C., first vice-chairman, U.S. Telephone Assn	85
Prepared statement	87
Kovach, Gerald J., senior vice president, MCI Communications Corp	79
Prepared statement	80
Marshall, Charles, vice chairman of the board, AT&T	73
Prepared statement	75
Questions of Senator Pressler and the answers	78
McArton, Robert A., on behalf of the National Telephone Cooperative Assn	88
Prepared statement	90
Questions of Senator Pressler and the answers	93
Nelson, Sharon L., chairman, Washington Utilities and Transportation Commission, on behalf of the National Association of Regulatory Utility Commissioners	53
Prepared statement	55
Patrick, Hon. Dennis R., Chairman, FCC; accompanied by John Kwoka Common Carrier Bureau; and Michael Wack	5
Prepared statement	41
Questions of Senator Pressler and the answers	48
Schwartz, Gail Garfield, on behalf of the National Association of Regulatory Utility Commissioners	61
Prepared statement	64
Shreve, Jack, on behalf of the National Association of State Utility Consumer Advocates	94
Prepared statement	95
Skinner, Frank, president, Southern Bell	83

ADDITIONAL ARTICLES, LETTERS, AND STATEMENTS

Bolger, Thomas E., chairman of the board, Bell Atlantic, letter	124
Murphy, Terence Roche Murphy & Malone, letter	123
Organization for the Protection and Advancement of Small Telephone Companies, statement	120

FCC PRICE CAP PROCEEDING

TUESDAY, AUGUST 2, 1988

U.S. SENATE,
SUBCOMMITTEE ON COMMUNICATIONS,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
Washington, DC.

The subcommittee met, pursuant to notice, at 9 a.m., in room SR-253, Russell Senate Office building, Hon. Daniel Inouye, Chairman of the Subcommittee, presiding.

Staff members assigned to this hearing: Tom Cohen, staff counsel and Gina Keeney, minority staff counsel.

OPENING STATEMENT BY SENATOR INOUYE

Senator INOUYE. The hearing will please come to order.

We gather this day to consider the FCC's price cap proposal and the bill proposed by Senator Kerry, to require further review of this matter.

Because of the importance of this proposal to rate payers in the industry, it has generated much interest and controversy.

The question before this subcommittee is whether the Commission has fashioned a proposal that properly shares the burdens and benefits, or whether it warrants much greater examination and deliberation.

For many years, the FCC has relied upon rate of return regulation to control the rates of telephone companies. Last August, the Commission initiated a proceeding to determine whether a better method of regulation could be employed, and it tentatively settled on the price cap approach.

This past May, the Commission issued a further notice of proposed rulemaking, setting forth how its price cap plan would work.

This price cap plan raises issues that go to the heart of telephone regulation and the proper balance between the interests of rate payers and telephone companies.

If this new plan strikes the proper balance, it might make all parties better off. However, if it does not, certain parties will obviously be harmed.

Over the past month, I have spent time reviewing this matter. I have looked at the Commission's proposal and its rationale, and I have met with many of the interested parties. From this review, I believe two conclusions can be made.

First, this price cap plan has serious problems that skew the balance away from rate payers, and that creates a significant possibility of harming the quality of telephone service in this country.

I gather that this conclusion is shared not only by rate payers, but by some in the industry. Many of these problems are easily solvable. However, others will take time to resolve.

Second, it would be a grave mistake for the Commission to move ahead on such an important matter without permitting the parties the time to fully air their concerns and arrive at a consensus. The Commission may have the ability to adopt the price cap plan before such a concession is reached; but that will not insure the success of the price cap plan. Success on fundamental matters can only be achieved by all parties working together and reaching an agreement that all find satisfactory.

As proof of this action, one need only contrast the success of the consensus-building effort on the second phase of access charges, with the failure of the go-it-alone effort on the first phase.

The Commission has come a long way since it first proposed price caps as an alternative to rate of return regulation. The plan released in May is impressive in its length and detail. However, many believe that it also contains significant weaknesses.

Before putting this plan into effect, many believe that these weaknesses must be resolved.

As our first witness, we have the very distinguished Chairman of the Federal Communications Commission, Chairman Dennis Patrick.

Welcome, Mr. Chairman.

Oh, Senator Pressler, I'm sorry.

I am sorry that I didn't see you come in.

OPENING STATEMENT BY SENATOR PRESSLER

Senator PRESSLER. That's all right, Mr. Chairman.

Mr. Chairman, I would like to make just a brief statement.

The price cap proposal advanced by the FCC is certainly intriguing. The idea is to encourage efficiency in the telephone industry, and I believe that it could very well accomplish that. Indeed, from a business or free market point of view, it is probably quite superior to the current rate-of-return regulation.

I applaud the responsiveness of the FCC to congressional concerns expressed this past Spring. The Commission came out with a much more detailed proposal which is quite attractive. There is one problem, however, and that is why I cannot support the price cap proposal in its current form.

The FCC neglected to provide safeguards for small telephone companies. These are the companies which serve the majority of South Dakota. Under any plan which deregulates the telephone industry in any way, it is the small companies (and their customers) which stand to lose the most. Safeguards, such as those provided in the existing Unity 1–A agreement, must continue under any new form of regulation. I know the FCC has assured us many times that they would provide such safeguards with price caps, but that is still only a verbal assurance. The nature of these promised safeguards must be put in writing prior to the introduction of price cap regulation. If this could be done, I think I would have little problem with proceeding with price caps.

Mr. Chairman, thank you for holding today's hearing on this controversial issue. I look forward to the responses of the witnesses to the concerns of the small telephone companies.

[The bill follows:]

II

100TH CONGRESS
2D SESSION

S. 2044

To require further review by the Federal Communications Commission to ensure thorough deliberation on proposed changes in the method of regulation of interstate basic service rates.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 4 (legislative day, FEBRUARY 2), 1988

Mr. KERRY introduced the following bill; which was read twice and referred to the Committee on Commerce, Science, and Transportation

---

A BILL

To require further review by the Federal Communications Commission to ensure thorough deliberation on proposed changes in the method of regulation of interstate basic service rates.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. TERMINATION OF PENDING PROCEEDING REQUIRED.

The Commission shall terminate, without further action, the proceeding in the matter of policy and rules concerning rates for dominant carriers, initiated by notice adopted

August 4, 1987, and released August 21, 1987 FCC Docket No. 87-313.

SEC. 2. CONDITIONS FOR INITIATION OF NEW PROCEEDING.

Except as hereafter expressly authorized by Act of Congress, the Commission shall not commence any other proceeding with respect to the establishment or alteration of the basic policy, rules, and methods used in the regulation of rates charged by dominant carriers for their interstate basic service offerings, except pursuant to a notice of proposed rulemaking which—

(1) is issued on or after January 1, 1989;

(2) contains the complete text of the proposed new rules and regulations necessary to implement the establishment or alteration of such basic policy, rules, and methods; and

(3) contains or is accompanied by such explanatory notes, supporting materials, and quantifiable data, that demonstrate by clear and convincing evidence that both business and residential telephone ratepayers will obtain comparable or better services at lower rates than under the current system of regulation.

Senator INOUYE. Senator Hollings, do you wish to make a statement?

OPENING STATEMENT BY THE CHAIRMAN

The CHAIRMAN. Today's hearing addresses an issue that is very important to the American public and our electoral process, candidates access to broadcast stations. S. 2657, introduced by Senator McConnell, concerns an important aspect of that access, the prices charged for political advertisements. This committee has long been concerned that political candidates have reasonable access to broadcast stations and that there be no discrimination in the rates charged for campaign advertisements. Section 315 of the Communications Act was adopted specifically to address that concern.

Section 315, as amended in 1972, requires broadcasters to charge candidates the lowest unit rate available for the time during which the advertisements are aired. We now hear charges that the lowest unit rate provision is not being applied properly—candidates are being charged more than the lowest unit rate. This disturbs me greatly. We already spend too much time raising money just to get on television. Now, we are told one of the reasons why.

I look forward to hearing the views of the witnesses here today so we can find out if any of these charges are correct.

Senator INOUYE. Mr. Patrick.

STATEMENT OF HON. DENNIS R. PATRICK, CHAIRMAN, FEDERAL COMMUNICATIONS COMMISSION, ACCOMPANIED BY JOHN KWOKA, COMMON CARRIER BUREAU; AND MICHAEL WACK, COMMON CARRIER BUREAU

Mr. PATRICK. Good morning, Mr. Chairman and Members of the Subcommittee. I do welcome this opportunity to appear before you today to discuss a proposed reform in the Commission's regulation of dominant carriers, that is, the price cap proceeding.

With me are Michael Wack, of the Commission's Common Carrier Bureau, and John Kwoka of the Bureau. John is also a professor of economics at George Washington University.

These gentlemen were instrumental in developing the Commission's further notice of proposed rulemaking in the price cap proceeding.

Mr. Chairman, I have submitted a rather detailed written statement in advance of the hearing. Instead of reading that statement, I would just like to make a few rather basic points about the proposal that we have before us.

But first, I want to underscore the substantial policy agreement that exists between the Commission and the Members of this Subcommittee concerning the regulation of dominant carriers in general and the price cap proceeding in particular.

Regulation is necessary to protect consumers. Our price cap proposal represents, we believe, improved regulation that is consistent with consumers' short and long-term interests, not deregulation of these dominant carriers.

We estimate that consumers' rates would be $1.6 billion lower over the next four years under price cap regulation than if we continue the existing form of regulation. The banding limitations on

rate changes guarantee consumers an additional measure of rate stability and predictability.

The proposal also should greatly strengthen carriers' incentives to offer a wide array of high quality services at cost effective rates. To be sure, we expect to secure these consumer benefits by offering carriers the opportunity to increase their short-term profits. But no one, particularly the carriers themselves, should operate under the illusion that price cap regulation constitutes profit deregulation.

It does not.

Carriers will only increase their earnings by meeting performance targets that are set higher than they would have been able to achieve under the current system. Under our proposal, consumers have the first claim on benefits of the carriers' superior performance.

The latest round of comments reflect a consensus on the need to move away from today's cost-plus regulation and adopt a more forward-looking incentive form of regulation.

Regulation of dominant carriers should be crafted in a way that conforms to the realities of the age of information and growing competition that helps improve the competitiveness of American industry in domestic and international markets, and, most importantly, that assures that consumers share in the benefits of this new age through lower rates and a wide array of high quality services.

There is no longer any serious dispute that the current regulatory approach does not fare well under that type of evaluation. The limitations of existing regulation are widely recognized, as witnessed by the growing number of State and foreign countries that have either implemented some form of incentive regulation or are contemplating doing so.

These regulators are acting on largely undisputed realizations that rate of return regulation creates perverse incentives for carriers to operate in ways that harm consumers. It provides incentives for carriers to pad their costs, to forego possible innovations and to cross subsidize their unregulated services.

It is difficult to enforce and expensive to administer.

Indeed, the government spends countless of hours and millions of taxpayer dollars trying to prevent carriers from following incentives that we have helped to create by our cost-plus approach to regulation. Certainly, many in Congress have long been critics of this cost-plus contract approach to regulation.

The idea of price caps is to turn the tables and structure regulation so that in the course of pursuing profits, carriers are also pursuing the public interest. In other words, price cap regulation is an approach that would facilitate, and not fight, our public interest objectives or goals.

Carriers are told: here is the mark; beat it and you may keep the additional profit for a while. Carriers that become more efficient and deliver high quality service would see their profits rise in the short run. Carriers that fail to become more efficient or maintain high quality service would see their profits fall.

After the fourth year of the plan, the mark will be adjusted in light of the Commission's ongoing monitoring efforts, which we would maintain. This approach emulates the workings of a com-

petitive market, where the most efficient and innovative firms retain greater short-term profits than their competitors.

It is important to emphasize, however, that in the long-term, base line rates would be adjusted downward under our plan, so the consumers ultimately are the beneficiaries of all achieved efficiencies.

Again—and I think this is an important point—this emulates the competitive market process, where short-term profits induce entry of competitors, and they bring rates down to a new and lower base line that consumers can participate in.

This acknowledgement of the inherent flaws of the existing regulation represents a significant movement, I think, from the response to the Commission's initial work on this issue. With very few exceptions, no one is arguing that rate of return is superior to some form of incentive regulation. Instead, the bulk of comments addresses issues associated with making the incentive-based regulatory system or structure work.

Thus, the debate has changed from whether we should move to incentive regulation to how we should move to that form of regulation.

To be sure, additional work lies before us. We must complete that task.

In crafting the proposal, we have already sought to incorporate the thoughts and the suggestions of Members of this Subcommittee and others in the Congress. We clearly have responded to the request by Senator Kerry and other Members of the Congress to provide more information, more detailed proposals, with respect to the price cap approach and the way we would propose to implement it.

We will now begin, and, I must say, are just in the process of beginning a detailed review of the comments that were filed last week in response to our further notice of proposed rulemaking. The replies, I might note, will not be filed until the end of August.

Finally, Mr. Chairman, the Commission has not and we will not rush to judgment in this matter. But, after we examine the record, if we conclude that price caps will make consumers better off than they otherwise would be, then, in my view, we should not delay the realization of those benefits by consumers by deferring the implementation of some form of incentive-based regulation.

Thank you, Mr. Chairman.

Senator INOUYE. Thank you very much, Mr. Chairman.

Some day, hopefully, someone will read the transcript of these proceedings, and, so that they will understand what we are discussing, can you give us a description of the rate of return approach and the price cap approach?

Mr. PATRICK. Yes, I can, Mr. Chairman.

Of course, comparing and contrasting these two approaches is key to the discussion.

Under the rate of return approach that we have today, the Commission first sets out to set a rate of return, that is, a number, a certain percentage of recovery over costs. We do that by attempting to estimate the cost of capital and evaluating comparable risk for firms that are facing comparable risks in the market. That is a very difficult and subjective process, I might note.

We identify the costs that the carriers are going to incur. We divide them among hundreds of accounts. Then we review tariffs. We review tariffs that are filed in tens of thousands of pages, which reflect the carriers' costs and then project what recovery the carrier will earn over and above those costs. We attempt to approve those tariffs based upon the idea that the carrier is entitled to recover costs plus about 12 percent.

There are a number of problems with rate of return regulation which were widely recognized, have been noted in the academic literature for years, widely recognized among the States, many of which States are moving away from rate of return, and, as I say, the Congress certainly has noted the inherent problems with cost-plus contracting.

Let me briefly tell you what they are.

They are administrative, legal, and, most importantly, they are incentive-based problems.

The administrative problems that we have are obvious. I have exactly 34 employees who, in the initial instance, review, are asked to review, tens of thousands of pages of rate of return tariff filings. They have to evaluate the propriety of these filings with reference to $50 billion in interstate revenue requirements. That is, needless to say, a difficult task. It is costly. NTIA has estimated that it costs about $1 billion for all of the parties to administer the rate-of-return system throughout the country.

There is a certain amount of aggregation and flexibility in the process. There is—and this is a key point—in the rate of return process, there is speculation or estimates of productivity, future productivity.

The reason I emphasize that is one of the critiques and concerns in the context of our rate cap proposal is the necessity to estimate productivity.

Well, Mr. Chairman, my point is that we have to do that today in the context of rate of return. But we have to do it on an individual tariff by tariff basis, and that is even more difficult.

There are legal problems.

Some say why don't you just do rate of return right. The problems with that are administrative resources and, second, legally, we can only disallow an investment by a carrier, the Court of Appeals has told us, if we can show the investment was imprudent when made. It is a business judgment, difficult to second guess.

Most importantly of all, the incentive problem with rate of return is obvious. There is an incentive in any cost plus contract situation to pad the rate base. If I am a CEO of an RBOC and I am at my rate of return, the only way for me to increase my dollar revenues is to increase my investment in the rate base. Consumers ultimately have to pay for that.

There is also an incentive to cross subsidize, and this is a terribly important, perverse incentive, as we allow the carriers to get more and more into the provision of competitive services. The reason rate of return creates an incentive to cross subsidize between competitive and noncompetitive is because if that carrier can convince the FCC that a dollar actually incurred on the competitive side was incurred on the noncompetitive, regulated, side, then we will allow them to recover the dollar on the regulated side. We eliminate that

perverse incentive with caps because it is capped. It does not do you any good.

There are also perverse incentives not to pursue innovations because, if you pursue innovations and it increases your rate of return, the next year the Commission will just bring your rate of return down or adjust the tariff, and so, there is no incentive to innovate in a way that would help consumers.

The cap proposal is really not a radical departure from the way we do things now in a procedural sense. What we are really talking about is changing the way we approach tariffs, how we think about tariffs as they come in the door.

Essentially, very briefly, the idea is this. We take current prices. We cap them. We adjust them annually by a formula that will bring down prices by 3 percent in real terms. That involves our estimate of industry productivity, plus what we call a consumer productivity dividend. And we adjust these year by year by that formula.

By focusing in the initial instance on prices, rather than the relationship between costs and prices, we replace the perverse incentive of cost-plus contracting to pad the rate base and to cross subsidize with the efficient incentive to cut and to innovate. We do it pursuant to safeguards that protect the consumer, both in the short-term and in the long-term.

In the short-term, because we have suggested a formula that will bring down rates each year by slightly more than that which we would anticipate under rate of return, they are sharing in these benefits from the very beginning. In the long-term—and this is really a key point—in the long-term, what we have done is we have given the carriers an incentive for the first time to reveal to us how efficient they can be. Now they have an incentive to hide that. Once they do, at the review period, we can bring rates down. We can adjust the base level of rates, or we can adjust the formula so as to insure that consumers will participate in those incentives.

So, we lower the rates. We replace perverse incentives with efficient incentives. We eliminate the incentive to cross subsidize, and we do it pursuant to a system that has a lot of safeguards in it, Mr. Chairman.

Senator INOUYE. In your notice, you cited these three problems. And yet, you cited no hard evidence of examples—just theory.

Do you have evidence that there is a lot of cross subsidizing, for example?

Mr. PATRICK. Yes, Mr. Chairman, we do.

I asked at or about the time of the initial notice, in response to questions such as this, that the Bureau go back and take a defined period of time and look at what misinvestments, what padding we were able actually to identify and disallow. For the given period of time that we looked at, about two years, as I recall, we found about $163 million in investments, which we disallowed as not being necessary; as, in effect, representing padding.

We also found for the last two annual access charge filings about $900 million in proposed access charges that we disallowed and found to be inappropriate.

I think the key additional point is this. But first, yes, we have that hard evidence, and I am sure if I took my very limited re-

sources, and caused them to focus on nothing but identifying misinvestment, we could come up with other examples.

But I think the key point here is that with the limited resources we have at the Commission and the size of the interstate revenue requirement, which is $50 billion, and the legal standard that the court has imposed, I can only disallow an investment if I can prove that it was imprudent when made as a business matter. That is tough for us to prove.

It is going to be very difficult for the Commission to police in an extremely effective way this investment problem. So our idea here is let's get the incentive structure working with our regulatory goals, rather than working against them. That, essentially, is the idea of caps.

Senator INOUYE. What impact will your price cap approach have on employment? Will it increase employment or lower employment?

Mr. PATRICK. I note that the CWA has filed in support of price caps, and that seems to represent their view. I would say that price caps will have no adverse impact upon their employment situation.

I think there is a common, and erroneous, reaction that efficiency means fewer employees, that it means a loss of jobs. I don't think it means that because, Mr. Chairman, you can increase efficiency by increasing the units of output per unit of input. If you keep the same level of input, the same level of labor, and increase the amount of output you get from that labor base, that increases your efficiency.

Under our plan, the carriers will be able to retain the fruits of that efficiency for a short period of time, until the review.

So I don't think it is going to have an adverse effect on labor.

Senator INOUYE. Senator Pressler.

Senator PRESSLER. Thank you, Mr. Chairman. I shall be very brief here as I have to go on to another hearing.

But there is one problem, however, and that is why I cannot support the price cap proposal in its current form. I might ask the witnesses to respond.

The FCC neglected to provide safeguards for small telephone companies. These are the companies which serve the majority of South Dakotans. Under any plan which deregulates the telephone industry in any way, it is the small companies and their customers which stand to lose the most. Safeguards, such as those provided in the existing Unity 1-A Agreement, must continue under any new form of regulation.

I know the FCC has assured us many times that they would provide such safeguards with price caps. But that is still only a verbal assurance. The nature of these promised safeguards must be put into writing prior to the introduction of price cap regulation.

I wonder if we could have a response on that.

Mr. PATRICK. Yes, Senator Pressler.

Had I to do this over, I probably would have had a more explicit section in our notice of proposed rulemaking dealing with this matter of protecting the small companies.

The reason we did not explicitly set forth the safeguards which we envision will be provided for the small companies is because those rules, which we have today—I am referring now to high cost

support—are in separate rules and they are not affected by this price cap proposal.

But let me be very specific in response to your concern, Senator, and say that the small companies are protected and customers in those rural areas are protected by most importantly two things. One is the high cost support, the subsidies that we provide for small companies whose costs are higher than the average. That cost support will continue and will not be adversely affected by rate caps. The only reason that is not discussed a great deal in the notice is because that is already in our rules and those rules are not affected by the price cap proposal.

The second, very important matter to the small companies, national geographic rate averaging.

This is a policy to which this Commission has been and continues to be committed, and it will not be changed by or adversely affected by rate caps.

Senator PRESSLER. In response to Senate and House Appropriations Committee report language, Mr. Fowler committed the FCC to follow a policy of using the formal Regulatory Flexibility Act procedures with respect to small company problems. This means analyzing the impact of proposed rules on small businesses before they are proposed.

Has the FCC adhered to Mr. Fowler's commitment in the price cap proceeding?

Mr. PATRICK. I think we have, Senator.

There is a section in the further notice, a number of paragraphs wherein we explicitly deal with the matter of small companies and concerns that have been expressed by the small companies.

As I say, had I to do it over, I probably would add some additional information in those sections. But, yes, I do think we have complied.

More importantly and substantively, we intend to continue to focus on the potential impact of this proposal on all carriers, including most especially the small carriers, to insure that they are not adversely affected.

Senator PRESSLER. Following that up just once more, do you plan to specify in the price cap rules that no toll rate deaveraging will occur under price caps?

Mr. PATRICK. That is not part of the proposal—well, actually, it is. We do specify in the further notice that—and I forget the exact language—but we do talk about the matter of geographic rate averaging, and we do indicate that we contemplate no change therein. I would assume that the report and order, without prejudging it, would reflect that similar language, because that is a policy of the Commission and will continue to be a policy of the Commission.

Senator PRESSLER. I have more questions for the record, Mr. Chairman. I will submit them for the record.

Senator INOUYE. Thank you.

Senator Danforth.

Senator DANFORTH. Mr. Chairman, thank you.

Mr. Patrick, let me first say that I don't have a position on this proposal. I know people in the room are very attentive to views of Members of this Committee on the subject, and I really have not formed a conclusion. I want to make that clear.

How long has the rate of return system been in place?

Mr. PATRICK. We have been using the formal rate of return procedures that we utilize today since about 1960. But it raises an interesting point, which is that rate of return regulation is not mandated by the Communications Act and has not always been used by the Commission.

Senator DANFORTH. But for roughly 28 years the same system has been in place?

Mr. PATRICK. That's correct.

Senator DANFORTH. I know that some people would say "well, why are you doing this? This is a big change. Change is bad." I don't necessarily believe that. I don't think that the FCC should turn off its mind because something has been in place for 28 years.

But, let me ask you what has happened that leads you to believe that a change should occur at this point?

Mr. PATRICK. I think essentially two things, Senator. One is that we learn as we go along. As we apply a certain approach to regulation, we learn about the defects or the faults or the perverse incentives that are created by that regulation. So we have learned.

Hopefully, after 30 years, we will learn something about our regulatory approaches, and we will seek to improve them.

I might say in that regard that the States, many of the States, are actually ahead of us in taking note of the fact that rate of return regulation is defective and that we need to move toward a system that will better serve consumers.

The second major change or factor that I think causes us to focus at this time upon this matter of changing rate of return regulation is the telecommunications market. It will come as news to no one here that it has changed so very dramatically in the last several years. I think it becomes even more important in light of some of those changes that we have a regulatory structure that is consistent with the evolution of that marketplace, that is consistent with the incentives that we have created by introducing competition and is not hostile to it.

Let me reemphasize one point in that regard very specifically, and that is this. We have made a public policy judgment, which I believe the Congress supports, to allow the local exchange carriers to provide enhanced services within the network because those sorts of services provided by the local exchange companies are the only ones which the average consumer will typically access.

But, to do that we have to worry about the problem of cross subsidies. Today we have a regulatory system in place which intensifies that cross subsidy problem. That is something new. That is a change, allowing them into these markets. Mixing the competitive and noncompetitive markets is a change, and it becomes even more important that we have a regulatory structure that supports our public interest goals, that support what we are trying to do for consumers, instead of fighting them.

Today we set up incentives and then we turn right around and try to regulate them and spend millions of dollars in doing it.

Senator DANFORTH. Well, is not the telecommunications industry going through a period of technological change and is it not believed that the advent of fiber optics and other technological developments will reduce costs to the telephone industry and therefore,

is one of the issues before us now whether these new technologies and the reduced costs that will flow from them will go to the consumers or to the phone companies?

Is that why this is an issue of moment? Is that why there is such intense concern about it now? In other words, if we are about to have dramatically reduced costs in telecommunications because of new technologies, I suppose those who would argue for rate of return would say: "let us pass those savings on to the consumers"; those who would argue for price caps would say "let us pass those new savings to the telephone companies".

Mr. PATRICK. I think the fact that we are in a period of technological change is another reason that suggests the utility of moving toward a rate cap form of regulation, because you are quite right, Senator, new technologies are being deployed.

If we are going to ensure that the cost savings of those new technologies are passed along to consumers, you are relying upon a very small number of persons who are reviewing tens of thousands of pages of tariff filings to make sure that those cost savings are in fact being reflected in the tariffs so that we can ensure consumers participate in those gains.

What we would like to do is move to a rate cap or incentive based regulatory structure which will intensify the incentive to deploy efficient technologies and cause the carriers, yes, in pursuit of short term profits, to reveal to us how efficient they can be, to not cross-subsidize, to not pad, to not try to hide the ball, so that we can ensure, both in the interim and at the periodic review, that consumers are fully participating in those efficiencies.

Senator DANFORTH. I do not see how you would do that.

Mr. PATRICK. Well, the way that we do that, Senator, is by deploying a system which will, for instance, not cause carriers to try to hide the ball in terms of cross-subsidies, and will cause carriers——

Senator DANFORTH. Even though did you not just say to them, "keep it?"

Mr. PATRICK. No, we do not. That is a very important point. We do not say keep it. I did not because I thought my answer to the Chairman's opening question was a little bit too long, go into this earlier, but we do not say keep it at all.

What we say in the formula is this, that we believe that industry productivity in the next X number of years is going to be about X, and we have suggested in the notice 2.5 percent. That is based upon historical data and that is based upon our projections of what we think will happen in the future.

But then we say, in addition to that, that because we believe that if you are incented to deploy this technology that you are referring to, Senator, because you can keep some of those short term profits, you are going to do even better.

So what we do, is we deflate prices. We propose to deflate prices every year on a cumulative basis by more than what we would expect to see in a rate of return environment, that is about three percent, which is to say about an additional half point per year.

So, my point in response to your question, Senator, is that we are ensuring that consumers share, up front, in those increased efficiencies that we expect under the rate cap environment. And, more

importantly, at the end of that period when companies have revealed to us how efficient they can be in pursuit of profits, we can adjust prices, we can adjust rates or we can adjust the formula in a way that will dramatically ensure that consumers participate in those gains.

Senator DANFORTH. Thank you, Mr. Chairman.

Senator INOUYE. Senator Stevens?

Senator STEVENS. Thank you, Mr. Chairman. Senator Danforth indicated he had not made up his mind. I want you to know that I have made up my mind. And I think this is the right direction to go. I represent probably the most rural area in the country as far as telephone services, communication services are concerned.

It is one-fifth the size of the United States and the third smallest in population. It seems to me there is a great deal of fear being expressed in the country about this though, Mr. Chairman, and I would hope that we would find some way to put this fear to rest.

I have heard similar fear expressed that was articulated by Senator Pressler, for instance, concerning the rural telephone groups. As we understood the original notice, it did not change the basic rules that effect those groups. Is that correct?

Mr. PATRICK. That is absolutely correct, Senator.

Senator STEVENS. If I understand your statement, your proposal does not deregulate profits or any services at all, is that right?

Mr. PATRICK. That is correct as well.

Senator STEVENS. So what we are really saying is in an industry that has tumbling technology and tremendous innovation and the possibility for substantial productivity, that the determining factor on the rate of return will be the ability of the company to operate under a cap that, by definition, is less or is going to be less than exists right now under the current rate of return concepts, based upon investment, right?

Mr. PATRICK. That is exactly correct. They will be challenged to reach a mark that will deflate prices every year more than what we would expect under rate of return, and we will continue to monitor the situation and costs in the interim so that we can dramatically lower costs at the review period.

Senator STEVENS. Well, I would say to the Chairman of the Committee and the distinguished Chairman of the Commission today, that I remember sitting at this table 20 years ago when Alaska was in the process of taking over from the military, the Alaska communications system.

We had to privatize that and make it subject to regulation. My predecessor Senator Bartlett, encouraged that to a great extent, and when I came in to office we were in the process of implementing that.

The difficulty we had was that the purchaser bought all of the Air Force's equipment and installations and that went into that rate base. And as technology developed, we tried to get some of that old stuff that had been maintained by the military out of the rate base.

But even though the cost of maintaining it was high, it still was providing a rate of return that could not be provided under the current system in any other way. And when satellites came we had the same problem. The old trunk line running down through south-

east Alaska, running on into Seattle, it was absolutely obsolete, but it was maintained because it was part of the rate base.

Now it seems to me that the current system ties up the operating income of a system to maintain obsolescence and does not let them turn to the utilization of new technology as quickly as it should.

In an area like mine, that is absolutely necessary if we are going to reduce costs. We are still the highest cost area for communications in the country. If we are going to come into the twenty-first century with the rest of the country, in terms of nationwide pricing, then this is an absolute necessity.

I hope that the current dispute between Congress and the FCC is not going to impede this process. My one comment to you is I would urge you to try to work out some seminars, not just hearings but some seminars, for some of these members of Congress so that they will understand what is going to happen.

You can use Alaska as a absolute example of what has held back communications with the concepts that currently exist on the basic rate of return basis. I think that this absolutely is the way to go, with the price cap concept. Again, it is voluntary, is it not?

Mr. PATRICK. It is. The current proposal is to make it voluntary, yes.

Senator STEVENS. Eventually I do not think it will be voluntary, once the consumers discover what flexibility this will have, particularly when you still retain the right to regulate profits. I think that is the key to it all.

Mr. Chairman, I am pleased you called this hearing. I would hope that we would allow this process to go forward and see how it develops and, above all, I would hope we would remember that gentleman in 1932 who said, the only thing we have to fear is fear itself.

Thank you very much.

Mr. PATRICK. Senator Stevens, if I could just comment very briefly on one point that you made, because I think that it is a very critical point. It involves the matter of rural telephone customers.

The fact of the matter is, with the introduction of competition we have created a more positive incentive environment in the so-called high end of the market and in the urban areas and in those areas that are served by multiple providers of telecommunication services. You have competition and competition causes carriers to be efficient and lower their costs, et cetera.

What about the rural areas where you do not have that competition? What we would like to do is create a regulatory structure that creates something akin to the same incentives that are created by competition, so that rural customers as well, can benefit by and participate in these efficiency enhancing moves which the telephone companies can make if they have the proper incentive.

Senator STEVENS. Thank you, Mr. Chairman.

Senator INOUYE. Thank you very much. Chairman Hollings?

The CHAIRMAN. I thought the rate of return was the incentive, Chairman Patrick, in the rural areas. In other words, under rate of return, if I develop in the rural areas, that is my investment.

And knowing that I have my investment protected with a guaranteed profit around 11 or 12 percent, it seems like there would be a greater guarantee of good service in rural areas. Under the price

cap, I do not know whether to invest out there to Katmandu or Kwashko or wherever those places are in Alaska.

I do not know whether I am going to get my money back or not, with the weather and everything else and whether there is going to be five or ten or some caribous that are going to eat the line in the middle of the year.

I mean, how in the world do I know? But I know on the rate of return. I just come up to you and say, this is how much it costs and give me my return. Now explain that to me.

Senator STEVENS. Now be careful. He has been around the caribou, lately.

Mr. PATRICK. I am always careful talking to the Chairman.

Mr. Chairman, you make a good point about one characteristic of rate of return, and that is that a carrier is relatively confident that if they make an investment, they will be able to recover that investment because whether that investment is good, bad or indifferent, it is difficult for the Commission to discover whether it was the correct investment, and it is generally passed through.

So that point is correct. I am making a slightly different point which is, that it may not be an efficient investment. It may represent an investment in the rate base which is not necessary which involves the adding of a cost which your rural rate payers are then going to have to pay for, that is not necessary.

An example would be the investment, the proposed investment in a $50 widget or a $100 widget, both of which do essentially the same thing. Well, today that carrier may invest in the $100 widget, even though there is no consumer benefit and, in fact, there is a consumer harm, because we now have 50 additional dollars in the rate base to pay for, when the $50 widget would work just as well.

So what we want to ensure is that carriers will not only make the necessary investments but they will assess the efficiency tradeoffs and they will invest in a way that promotes the interests of consumers.

Innovation in rural area—today if a carrier proposes to deploy technology which is very innovative and increases demand and therefore their rate of return, they may find the next year that we turn around and adjust their tariff downward so they really have no incentive, or they have less incentive, to deploy that technology.

I think it is fair to say they have less incentive to be innovative. So if they were looking at an incentive based regulatory structure, they would have that incentive to be innovative and to invest only where it serves the interests of consumers and is efficient.

It is an improvement in degree, but I think a substantial degree, in the incentive situation.

The CHAIRMAN. Well, if you adjusted the rate downward, you would still get, your 12 percent profit. I cannot get the pitch, because you act like government started yesterday. We have had 50-some years of experience already.

We have all bragged about it, we have said we have low cost, magnificent service. The American system and all of the Bell Companies, they all describe themselves like a bunch of lethargic bums, but I have always known them to be pretty competitive.

They have always hired the outstanding personnel, professionally and public relations-wise. In my community, I have observed them

for over 50 years, 40 years in government at least, and they have always been good. Everybody has bragged about it.

In fact, the misgiving is about the deregulation and the break up. So let us start where we are. We know under the rate of return that it has worked extremely well at a low cost.

Now the financial analysts, on the other hand, come in and say this is a wonderful thing. You know, they sell stock and all of this, they say if this price cap malarkey can continue, it will increase their profits five or six percent. Instead of getting twelve they will be getting 16 and 17 percent.

All of the financial analysts tell us that. Yes, the rate payers would get, instead of about $4 billion, only about $400 million. In other words, the benefit to the industry would be around $4 billion and the benefit to the consumers will be around $400 million. About a ten-to-one difference in there.

Now that is what the financial analysts are saying and that is why this committee has grave misgivings, because we cannot understand why the Bell Companies are all enthused. If I have got a guaranteed profit and I am supposed to be lethargic, why all of a sudden I am enthused about this thing that lessens the chance of me obscuring the cross-subsidy.

And if I have got wonderful chances, as you have described them, for cross-subsidy on rate of return, why do I want to give that up and make less and be thrown into the briar patch of competition?

Mr. PATRICK. Mr. Chairman, you have made three excellent points. Let me see if I can remember them and respond to them in kind.

Let me take your last one first. Why are these companies enthusiastic about this? Well, I will tell you. I will say, very candidly, that I think there is more enthusiasm at the top of the companies than there may be at other levels of the company.

The reason for that is simply this. You talk to a CEO of a regional Bell operating company, as I have and I am sure you have as well. They will say to you, we want to be efficient. I would like this company to be very efficient, to provide the level and quality of service that American consumers want at the least possible cost.

But it is very difficult for me to be sitting around the table with all of my senior managers and pound the table and say, go out and lower costs and be efficient, when they all look right back at me and say just what you said, Mr. Chairman, which is why should we.

The CHAIRMAN. You fire them if you say that to you. Go ahead. Nobody believes that now. Let us move to the next point. If I am the manager and I say let us get efficient, and the fellow in front of me across the table says let us stay inefficient, he is gone. All right, let us go the next point.

Mr. PATRICK. Mr. Chairman, I would like to just briefly say——

The CHAIRMAN. I never heard of such nonsense.

Mr. PATRICK. Their response to you, whether or not they admit that they are not going to be efficient, is that it is difficult to motivate a company to save dollars when it is not going to profit by, in any way, the saving of those dollars, and when in fact, no matter what it invests, it can recover that investment from the Commission.

And the point is, not that it hurts the company. The point is that it hurts consumers, because we are all paying for that padding in the rate base that we do not need to pay for.

The second point that you made was one that is often made, which is, you know, things are pretty great. Rates have been coming down and we have a good telephone system. Why change things now?

There are a couple of responses to that. The first is that the dramatic reduction in interstate rates that we have seen in the past few years, something on the order of a 35 percent reduction in interstate rates post-divestiture, has been a function of two things.

One is competition and two, probably more importantly in terms of percentages, is the access charge program and our flowing through to consumers of access charge reductions paid by the interstate carriers, so that when their cost of access went down, we required them to pass that along to consumers.

We have provided for that same sort of methodology in the rate cap proposal, so that is even-steven. Now the reason that I think that we have to take a system which is pretty good and try to make it better is that there is a whole additional arena of costs out there that do not have to be incurred, that represent padding that consumers are paying for today and that are very difficult for me to detect with the meager resources that we have.

And, frankly, you could triple the size of the FCC and it would still be very difficult for the Commission to detect padding in an interstate revenue requirement of $50 billion.

The other thing, very briefly, as to why change seems pretty good, is a point that I made earlier. That is that the market has changed. It has changed dramatically. We now have a mix of competitive and noncompetitive services being provided by these companies.

I think that it is terribly important that we get the incentive structure consistent with, not hostile to, the evolution of that competition, keeping the costs of competitive services disaggregated from the costs of regulated services.

Your third point was, what about the financial analysts? They seem to be very happy because the companies are going to make a lot more money. The only point that I will make here, very briefly, is that this is not a zero sum game. This is not a situation in which the profits of the carriers going up necessarily means that consumers are paying more.

In fact, both can benefit. The essence of the proposal is that you identify inefficiencies, padding, and you split the difference. We ensure that consumers are paying lower rates than they would have paid under rate of return. Those carriers that can beat the market, just like in a market place, that can beat the three percent mark, for deflation each year, can earn a little bit more in the way of entrepreneurial profits each year until we get to the review period, and then we adjust everything downward. Again, emulating the function of a competitive market.

So, financial analysts may be happy that these carriers, the efficient ones, may make a little bit more, but it does not mean that consumers are going to be worse off. In fact, consumers are going to be better off.

The CHAIRMAN. If the price cap plan is so great, then why is it voluntary?

Mr. PATRICK. Well, that is a question that we have put on the table. We have proposed to make it voluntary in the initial instance, and we did that out of concern for the small companies and the rural companies who might find it difficult to match the productivity mark that we are proposing, which, frankly, is a fairly aggressive deflater, because we want consumers to participate in the increased efficiencies.

We thought it would be safer to proceed incrementally until we had some data and some experience with this.

The CHAIRMAN. Thank you, Mr. Chairman.

Senator INOUYE. Thank you very much. Before I call upon Senator Exon, I hope the record will show that we have this morning participating in this hearing, the Chairman and the ranking member of the Full Committee and eight members of the Subcommittee. That is eight out of 11, which would indicate to one and all how important we feel this matter is.

The CHAIRMAN. Mr. Chairman, if you would yield, we have in our Appropriations Committee what we call a dire emergency supplemental, and they will start at 10:00 and I will stay as long as I can.

Senator INOUYE. I will try to join you there. In the meantime, will you protect my interests?

The CHAIRMAN. Yes, I will do so as much as I can.

Senator INOUYE. Thank you. Senator Exon.

Senator EXON. Mr. Chairman, thank you very much. Chairman Patrick, let me ask you what I think is a key question. What is the FCC's time table on this proposed pending price cap rule making?

Mr. PATRICK. Senator Exon, the Commission began the public debate of this proceeding or this idea some two years ago. We had a notice of proposed rule making outstanding for approximately one year. The reply comments are due at the end of August and thereafter the staff of the Commission will evaluate those comments and in due course make an evaluation and recommendation to the Commission.

Senator EXON. Let me press you a little further on that. As Chairman of the Commission, you ought to have some idea I would think at this time, as to what is likely going to be happen.

What do you think will be the position of the FCC after the staff makes its recommendation? Are you likely to act immediately? That is why I asked you the question about what your time table is. Or are you more likely to put this over for consideration by the Commission when we have a full Commission, very likely some time after the first of the year?

Mr. PATRICK. Senator, the only reason I hesitate is because not having reviewed the comments and therefore not having reviewed the record as it exists today, it is very difficult to say whether the Commission will find the record adequate to move forward.

Our timing in these matters is always, needless to say, affected by, in fact, controlled by, the adequacy of the record. That having been said, if the Commission staff evaluated the record and believed that that record was adequate to make a recommendation to

the Commission, it is not inconceivable that the matter could be presented to the Commission before the end of the year.

The proposal in the notice would not have, under any circumstances, this plan actually take effect until the spring of 1989. That would be the earliest conceivable date for rate cap tariffs to actually take effect.

But I do not want there to be any misunderstanding. So, I want to say that if the record is adequate, it is not inconceivable that the staff could be in a position to make a recommendation to the Commission before the end of the year.

Senator EXON. If you were a wagering man, which I assume you are not.

What would the odds be that the present FCC would act before sometime in 1989? 50–50, or 75–25, one way or the other? Or what?

Mr. PATRICK. Senator, I do not want to be evasive, but it is very difficult for me to answer that question before I have even had a chance to look at the comments, indeed before the comments are even in.

If the comments do not provide a basis for the Commission to believe that it can move forward, confident that we are promoting the public interest, then the Commission would not move forward. I would be in a much better position to answer that after August, when we have this round of comments in.

Senator EXON. I understand and I think that is a key question that is on many of our minds around the table here this morning, and that is why I asked it, and I accept the statement that you have just given. If I were in your position I think I would take exactly that position given the situation as we presently view it.

Let me ask you this. I may be following up on some of the questions that were raised by my colleague from Alaska, about rural areas.

Under the present program, at least it was intended that since the costs in rural areas are obviously higher than costs per customer in high density population areas, the present plan supposedly would encourage telephone companies who serve rural areas to make investments in those rural areas and have a chance to get back their money plus a reasonable profit.

If this price cap matter would move forward as presently planned, how would that likely affect rural areas? I think many of us fear that it might—I say might because I am not sure—but it might adversely affect and deteriorate the service in rural areas exactly like the deregulation of the airlines has been unfavorable to rural areas because the money and the service have been concentrated by the competing companies in areas where an awful lot of people live.

I have some fears in this area, and I am wondering if, as Chairman of the Commission, if you share those concerns.

Mr. PATRICK. Well, the answer to your question, Senator Exon, is that I have those concerns. Those concerns are among the issues that we are thinking very carefully about. But my tentative conclusions are that the rural areas would not be adversely affected by the rate cap proposal and, in fact, would be affected in a very positive and beneficial way.

The reason I say that, is this. The rural areas, as you know and have pointed out to me on a number of occasions, have not benefited to the same degree from the advent and the entry of competition into telecommunications markets because that competition tends to focus on the high end of the market, the urban areas, etcetera.

That means that you do not have the incentives that are created by competition operating in the rural areas. That may mean that rural areas are—rural telephone companies—are not doing everything they could do for consumers in the way of being efficient, in the way of cutting costs and in the way of introducing innovative programs, etcetera.

What we would like to do by this rate cap proposal is, by holding forth the carrot of the potential of increased profits for a period of time, create an incentive which is very similar to the incentive that is enjoyed by customers in the urban areas where there is a lot of competition.

We simulate or duplicate those positive incentives in the rural areas, so I think it will be positive for rural customers if the high cost problems of the rural telcos are dealt with at the same time, and that is a related issue. But, we have taken great efforts, and will continue to take great efforts, to ensure that the rural companies continue to enjoy the high cost support that they enjoy today so that they will continue to enjoy those very necessary subsidies.

Senator EXON. Thank you, Mr. Chairman, and thank you, Mr. Patrick.

Let me say that I will continue to look at this very carefully. I have not made up my mind one way or the other, but I have expressed here this morning in my questioning some of the concerns that I have. I hope that you, as Chairman of the FCC, will bear those in mind and indicate the same to other members of the FCC.

Thank you very much, Mr. Chairman.

Senator INOUYE. Thank you.

And now we hear from the author of the measure that we are considering, Senator Kerry.

Senator KERRY. Thank you very much, Mr. Chairman. I appreciate it and I appreciate the fact that you are holding this hearing.

My concern, which was expressed at the outset of this process, when the Commission first talked about moving in this direction, I think remains as high today, notwithstanding the promulgation of the further directives as to how they are going to proceed.

I think this hearing is important.

We know that in the House, the Members there found some serious flaws with the current proposal. I think what we are really looking at is the issue not so much of whether or not there may not need to be changes in the rate of return process, but whether or not we should move precipitously at this point with a number of unknowns out there to implement a plan which would have such broad effect on all businesses and all consumers.

I think there are a lot of questions, more than we can even probe with here today, about whether the baskets that are currently planned are the appropriate ones, whether there should be protection for the small users and small businesses, putting them into a separate basket, so you are really going to hold them harmless and

not have cross subsidy in some way, and leave it up to theory to pan out as promised.

The 2.5 percent productivity figure is one that concerns me enormously, particularly when measured against the British experience. I would just like to probe a few questions with respect to those things because obviously we are not going to resolve it all here today.

Let me ask you, Mr. Patrick, would you not say that the telephone system that we have in this country today is by far the best system in the world?

Mr. PATRICK. Senator, I know that we all say that, but I have no idea whether it is the best system in the world, not having participated in or utilized all the other systems in the world.

I know that we have a very good system. I think it could be better. I think that improving the incentive structure so that carriers are incented to act in a way that is consistent with our policy goals, rather than hostile to them, could improve the situation that we have.

Senator KERRY. We could, I suppose, probe about some of those specific improvements that you think might be necessary. But before we do that, let me ask you this.

You rely heavily in your model for this price cap on the British price cap plan, which uses the formula of RPI minus 3 percent. The British recently announced that they are revising their formula to RPI minus 4.5 percent.

So, could it be that the formula that you have proposed is, in fact, wrong?

Mr. PATRICK. Senator, the fact that we want additional information and will utilize that additional information to craft precisely the correct program and come up with precisely the same productivity factor is manifest in the further notice. That is why we did the further notice.

So, until we resolve that, I am not going to sit here and tell you that I am absolutely positive that 2.5 is the right number.

But let me get back to the British experience and say two things. The fact that the British, after several years of utilizing price caps, have decided to retain that system, are quite pleased with that system, and have moved from a deflator of three to a deflator or productivity factor of 4.5 is great evidence in support of the proposition that caps work.

The reason you expect to move to a more aggressive formula in terms of deflating prices is that the companies cannot instantly respond to an improved incentive structure. One expects that, over time, they will organize themselves in a more efficient way, so as to be able to respond to these efficiency incentives, and that is why you see the British moving from three to 4.5.

The second point is this.

You cannot compare the British telecommunications system or BT's cost structure directly to the United States. BT was privatized in 1984. So the padding, the efficiency or lack thereof, in that system may not have anything to do with what we find here.

That is why we are basing our proposal on data that we have ascertained with respect to U.S. companies.

Senator KERRY. Well, if you are going to crow about the British experience and rate of return, you might be underscoring some of the concern which some of us are expressing here. Great Britain adopted its plan and, incidentally, moved from a totally state-owned structure into a whole new realm, as you have just said—so I don't think the situations are comparable.

But the British Telecom rate of return has ranged from 19.2 percent in 1985 to 20.2 percent in 1986, to 20.4 percent in 1987.

UPI, on May 18, reported that a high AT&T official acknowledged his company's hopes that your plan would help his company achieve a 20 percent rate of return, and, in fact, investor letters, which are being sent out from Wall Street and various investing companies, are advising people that if this plan goes through, telephone stock is, in fact, going to be one of the best opportunities in the country.

So, are you considering now that a 20 percent rate of return is fair and reasonable?

Mr. PATRICK. Senator Kerry, there are a couple of points.

The first is that the British, as you probably know or may know, compute the rate of return in a very different manner than we compute ours. So it is very difficult to compare rates of return.

Senator KERRY. Well, you just did it. I mean, you just used it as the foundation for your answer to the first part of my question.

Mr. PATRICK. No, I don't think that is correct.

What I did in my earlier answer was to say that the fact that the British have moved from three to 4.5 in terms of the productivity factor was evidence of an industry responding to an improved incentive structure.

Senator KERRY. Let me just tell you why I am concerned and why I think a few months is necessary. You know, we are talking about a few months here. What we are talking about is time to study this.

Now, AT&T, in their testimony, submitted today, is going to tell us that for the local companies, the productivity may be 7 percent.

Now, if the productivity is 7 percent, and you are basing your consumer dividend adjustment on 2.5 percent, the difference is the $400 million that you say you will be saving consumers and $4 billion that will be overcharged to consumers.

Now, we are not talking about nickels and dimes here to consumers in this country. We are talking about the possibility of $4 billion in overcharges if one of the largest providers, dominant carriers, is correct in their assumption about productivity.

Now, I think we ought to know that before we move forward.

Mr. PATRICK. Senator, the thrust of your question goes to the importance of the productivity factor. I do not contest the proposition that the productivity number is important. That is why we have set forth in response to Members of Congress, in response to concern that you, in particular, have expressed, our best evidence and our best data, our best analysis of productivity for the companies, and solicited more.

We expect to receive more of that information.

But let us not lose sight of the fact that, in addition to the productivity numbers being important, it is equally important, and I would say in the long run it is even more important, that we put

into place a system of incentives that will cause carriers to attempt to be efficient, rather than causing carriers to attempt to pad the rate base in order to pump up the rate of return. That is equally important.

Senator KERRY. Well, what are the efficiencies that you are really talking about? We have digital switching, we have fiber optics, we have a whole new series of business options that have been offered in the country. We have night and weekend rates that are, what, 35 percent and 50 percent below the daytime rates.

I am told that those rates will disappear under the price cap system, that we may even lose those 50 percent and those 35 percent reductions.

So what are the innovations that you keep referring to?

Mr. PATRICK. Well, Senator, as you may know, I am not a technologist. I am not an expert with respect to specific technologies.

If you would like us to supplement the record, we can talk about all of the technologies that are potentially available that might involve saving dollars for consumers.

The larger point is that today, in a rate of return environment, take any one of those technologies that we might identify. If a carrier is about to deploy a certain piece of equipment and that equipment costs $100, rather than $50, there is very little incentive for that carrier to make the efficiency tradeoff as between whether it better serves consumers, is more efficient, is more facilitative or supportive of their goal of serving the public, and to trade off what the value is added by that piece of equipment, as against the additional cost.

The reason for that is if they invest in the $100 widget, not only are they no worse off, but, in fact, they are going to earn a rate of return on those additional $50.

So, it is a question of investments on the margin. It is a question of degree. It is a question, in essence, of efficiency, of the sort of tradeoffs that competitors make and evaluate when they are facing competition. The carriers, who are not facing sufficient competition, don't have to make them, and we would like them to make those tradeoffs because those tradeoffs help consumers.

Senator KERRY. There is a lot of theory in the answer that you just gave me and, frankly, not a great deal of empirical evidence that has been presented us that really supports that that kind of innovation will flow from these specific changes.

Now, I understand that the rate of return system is perhaps overly capital base oriented and reflects, therefore, investment incentive, rather than innovation and other kinds of efficiencies.

But when you compare what has happened to the system in this country over the last few years, and the potential for this to just totally turn it, discombobulate it, I am just uncertain that we really have the answers to those questions that I have even posed now and to many others that we do not have time to pose here.

Others have asked about the timeframe here. I wonder why there is such a rush to judgment on this.

Mr. PATRICK. Well, Senator, I think we are talking more than about theory. We discussed a little bit earlier the fact that when we look at any given period of time in terms of the access filings or in terms of the tariffs that are filed, we can identify costs that we

have disallowed, and we have done that. We have identified those numbers for the Committee.

The larger point is that this Congress could triple the size of the FCC and we would never be able effectively to second guess the judgments of 1,400 local exchange carriers with respect to the investment and the rate base. So, what should we do?

What we should do is create an incentive for them to make those tradeoffs in a pro-consumer way themselves. That is not just theory. I think that approaches intuition.

It certainly is a fundamental assumption of the market system.

Senator KERRY. I understand that, and I am not arguing with that. Believe me, I am not arguing that there is not room for some thought about how you improve the incentives in the rate of return system. I do not argue with that at all.

But there are some who have suggested that it is not the regulatory system as much as it is the regulators and their approach that is the problem.

Let me draw your attention to an article that appeared recently in the "Federal Communications Law Journal," entitled "The Averich-Johnson model in the Telecommunications Industry," as written by Brooks Albery and Mark Severts. Maybe you have seen it.

They are economists, employed by Southwestern Bell. I draw your attention to their statement, where they said, "In considering a redesign of this fundamental regulatory mechanism, it is critical to distinguish between the limitations of the rate of return standard as a regulatory device and the failures of the administrative process to maintain this form of economic regulation in an effective and viable manner. If rate of return regulation is abandoned for the wrong reason, its replacement will be far less effective in assuring competitive results in less than fully competitive market segments."

Now, shouldn't there be a more careful examination of actual data before we just reject in whole cloth the current regulatory system?

Mr. PATRICK. Senator, number one, there should be a careful examination of the proposal to alter our approach to tariff review. I guess that is one of the points that I would reemphasize.

What we are talking about here is a change in the way we evaluate tariffs that are under the cap and within the bands that we have proposed. It is not really a radical departure from what we do today procedurally, especially given the fact that we propose to retain the filings of information with respect to costs. So it is not that radical a departure.

But, yes, we should carefully evaluate the proposal. We are carefully evaluating the proposal, and we will continue to do so.

With respect to the first part of your question, rate of return regulation, if it were working perfectly, it would protect consumers. We all concede that and understand that.

But rate of return also is imbued with a certain anomalistic characteristic, which is that it creates the incentives for the carriers to behave in a way that makes it harder for us to make rate of return work.

It creates an incentive to pad. It creates an incentive to cross subsidize, and then we turn around and spend millions of dollars to correct those problems.

I have no problem with rate of return as a theory, if it were working perfectly. I think this Commission has made efforts to improve, and has improved on the margin our ability to administer rate of return.

But no amount of resources devoted to the FCC will ever perfect that system or ever create a situation which is more protective of the interests of consumers than a system which will cause incentives to be consistent with our policy goals, rather than hostile.

Senator KERRY. Do you believe that demand for telecommunications is going to increase?

Mr. PATRICK. Demand—excuse me?

Senator KERRY. Demand for telecommunications services, as we currently define them—is that going to increase?

Mr. PATRICK. I think, in general, demand has increased. I would not want to say that demand for every telecommunications service will increase.

Competition has a way of driving prices to costs. As costs go lower, you stimulate traffic, and, therefore, you increase demand.

Senator KERRY. But it is fair to assume, as businesses grow, as the country grows, as population grows, that demand is going to grow for telecommunications services. The communications industry will certainly tell you that everything they are doing is premised on that.

Mr. PATRICK. I think that is generally a fair assumption.

Senator KERRY. The effect of the increase in demand on the cost of services is what?

Mr. PATRICK. Senator, I apologize. I did not hear your question.

Senator KERRY. The effect of the increase in demand for those services, generally speaking, on the cost of those services, is what?

Mr. PATRICK. It depends on a number of things. It depends on whether you are talking about increases in the growth of demand or aggregate demand overall. But, in an attempt to answer your question, if you are talking about fixed costs, obviously, if you have more units of demand over which to spread a fixed amount of cost, that brings down the cost of service, as to those fixed costs.

Senator KERRY. And does the price cap formula take account of and adjust for increased profits, which come from a rise in demand with a decrease in cost?

Mr. PATRICK. The short answer to your question is yes.

We are dealing here with the matter of growth in demand, and the matter of the stimulation effects of, for instance, a reduction in access charges that are paid by an inter-exchange carrier.

As I say, the short answer to your question is yes, although how we administer that is among the questions that we discuss and explore in the item.

Senator KERRY. It's essentially arbitrary, though, isn't it?

Mr. PATRICK. It is certainly no more arbitrary—no. The answer to that is no.

Senator KERRY. Well, it is an arbitrary as the process today because it relies on your formula.

Mr. PATRICK. That is precisely my point, Senator. These questions of how you deal with stimulation, how you deal with growth in demand, which are thought to be flaws in the rate cap proposal, in fact, they are simply difficult issues that we have to deal with every day in the context of rate of return.

So, we are sort of at a status quo situation with respect to those problems.

What rate caps goes to is creating an environment that will reduce costs over time rather than increase costs over time.

We are still going to have to deal with the stimulation effects. We are still going to have to deal with growth in demand and how to factor that in. But we are dealing with that and we will do that.

Senator KERRY. Mr. Chairman, I know that I have over-extended my time. I wanted to follow up, but I will wait until the next round and will come back to this.

Thank you very much.

Senator INOUYE. Senator Packwood.

Senator PACKWOOD. Thank you, Mr. Chairman.

Chairman Patrick, when we deregulated trucking, we did it with some degree of confidence that there was adequate competition. And, indeed, it turned out to be true. You can rarely find a disgruntled shipper in the country in terms of trucks, they have so much opportunity for competition.

On air deregulation, it has been mixed. In Oregon, it has been fine. I have more carriers going to Portland than I used to, and I have more intrastate carriers in service than we had before deregulation, and good competition.

Where is the competition in local telephone service? I don't mean for big companies. I mean Mrs. Jones, who uses her telephone. What is the competition?

Mr. PATRICK. Senator Packwood, let me make two points. The first is that there is some competition, even at the local service level. I really urge you, as I know you will, to put that question to the representatives of the carriers who will testify before you in a few moments, or today sometime, I assume.

There is competition at the local level. Bypass is a form of competition.

I was having a discussion just the other day with representatives of U.S. West, who explained that they are absolutely facing competition at the local level in the form of entire planned communities who are setting up, in effect, shared tenant services for a certain portion of their local service, as distinguished from using the full panoply of switching capacity of the local service company. That is a big form of competition.

Senator PACKWOOD. Run that by me again. What are they doing? You have a planned community. Do you mean like a Reston or a Columbia? They are doing what?

Mr. PATRICK. I don't have all the details. This is a conversation that I had yesterday, and I was surprised by this information, as are you.

Basically, as I understand it, we are talking about a community development wherein the planners take into account telecommunications, much as the builders of a certain building will create what we call a "smart building," wherein they internalize the telecom-

munications services—taking that concept on a broader scale and applying it to an entire community.

But let me not lose your essential question and get back to this matter of competition.

There is not as much competition, certainly, at the local service level, especially in the residential markets as we see in the interstate market. But the rate cap proposal does not assume the existence of competition. It is not deregulation, like we saw in some of the industries to which you referred.

It is an improved form of regulation, wherein we assume the carriers have market power that we have to regulate. We are just trying to regulate it in a way that makes more sense.

Senator PACKWOOD. Well, I hear what you are saying. Again, I think of my mother, my aunt, my uncle, or anybody else who is living in a single family household in older areas. Do they have competition? Can my aunt call up somebody other than Pacific Northwest Bell and say I want a telephone and I want to call my neighbor on it?

Mr. PATRICK. For local service? Typically, a residential user for local service does not have the competitive options that others do. That is correct.

Senator PACKWOOD. Then is the fear at all justified that if the residential, if the local companies have price caps, there is the possibility of their attempting to pare service or costs in the hope of widening their profits, and not be worried about competition?

Mr. PATRICK. Senator, the answer is no, that nothing from our proposal would cause that result because, of course, we, the FCC, only regulate interstate access, as well as the interstate provision of service, and we do not regulate, as you know, the provision of local service.

Nothing in this proposal would bring about that result.

That is number one.

Number two, we have not really gotten directly into the matter of quality, but your question is dangerously close. Would the carrier allow the quality of service, the level of service, to degrade as a result of rate caps. I think the answer to that is no, for anyone of a number of reasons, and I will elaborate, if you like.

But the key response is that no, because we don't regulate local rates.

Senator PACKWOOD. Thank you, Mr. Chairman.

I have no other questions.

Senator INOUYE. Thank you.

Senator Breaux.

Senator BREAUX. Thank you, Mr. Chairman. I will have to try this without my microphone since I think it is defective.

I will start out by saying, Mr. Patrick, thank you for being here. That is number one.

Number two, I basically like the concept of a company being able to increase its profit margins because of the fact that it is more efficient, as opposed to the fact that their profits are increased because they are spending more money. I think that is the point you are trying to make in promoting the idea of a price cap.

I think that a company should be successful because they are more efficient, not because someone has set an arbitrary rate of return based upon how much they spend.

So, generally, I think your concept is one that I like.

But let me ask you some of the questions that occur.

The concern has been expressed by some of the smaller companies that their small company concerns are not being addressed by the proposal, and that until the small company safeguards are included, they certainly are not in a position to support the concept of a price cap proposal.

How are you planning, or how does the Commission plan, to address those small company concerns that you are missing at the present time?

Mr. PATRICK. Senator Breaux, we have addressed the concerns of the small companies in a number of meetings that I have had with the small companies. They were expressing some anxiety about the impact of the program on the small companies. We have reassured them of two very essential points.

The first is that we contemplate no change in the level of high cost support that the small companies enjoy, that we will continue to insure that NECA receives the data that it needs to compute the level of high cost support that the small companies are entitled to. That will not be changed. Also rate caps suggest no change in our historic commitment to geographic rate averaging, which is also a matter of concern.

I think what we will have to do is, in any additional pieces of paper that are issued in this proceeding to make those things clearer than I thought they were the first time.

Senator BREAUX. In other words, you are planning to modify the proposal perhaps to include additional specifics or to spell out what you intended in the general proposal? The small companies speak to the protections under their Unity 1-A Agreement as being lost under this proposal. Is that going to be cleared up with any additional proposals by the Commission?

Mr. PATRICK. Yes. The short answer is yes.

I don't think anything in the rate cap proposal actually compromises the Unity 1-A safeguards. But I understand that anytime there is an important change being made, one is interested in having reassurances of those facts, and I think we can provide those.

Senator BREAUX. Have we not, as a Nation, had some experience with some States trying to go to a price cap formulation with their State regulatory bodies? Do you have any experience as to how that has worked in those States that have tried?

Mr. WACK. Senator, on the next panel you will hear from Gail Schwartz of the New York Public Service Commission, where they have had price caps in effect since 1985. They have price caps in effect in New Jersey for local exchange carriers. They have it in more than—I think it is almost 20 States for AT&T, some price cap approach.

We have drawn on that experience at the State level in fashioning our own plan, and all of this is discussed in the further notice.

Senator BREAUX. Just for the Committee's benefit, what is the impression of the Commission of those local communities or States

that have set into effect a price cap mechanism for regulatory work? Is it successful or not successful?

Mr. PATRICK. It is generally positive.

I would add to the list of States that were mentioned by Mr. Wack of South Carolina, which has a rate cap proposal or a plan—not a proposal, but a plan—in effect, and they have been pleased with it and filed comments reflecting the fact that they were pleased.

I also note, and Senator Kerry can correct me if I am wrong, but I believe the Attorney General of the State of Massachusetts has recommended to the State PUC that Massachusetts adopt, in effect, something akin to a rate cap plan.

So there are many States that have moved toward rate cap regulation, and their experience has generally been positive.

Now Gail Schwartz, of the New York Commission, has been a leader in proposing that that State move towards, and that State did adopt a form of, incentive-based regulation.

Now, candidly, she and I have a disagreement as to how best to perfect the way one implements an incentive-based regulatory system. But I think the essential point is that New York has recognized the rate of return regulation is flawed, that it hurts consumers, and that we have to move toward a better incentive structure.

Senator BREAUX. MCI's testimony talks in terms of their position that price cap regulation is not appropriate for the LECs, the local exchange companies. Now AT&T, you can say that that is one thing. But for local exchange companies, it is an entirely different matter, and you are trying to craft something that meets the concerns of both. As a result, you don't meet the concerns of either.

How would you respond to that?

Mr. PATRICK. I would respond to that, Senator, by saying, as I mentioned a little earlier, that were the Commission proposing deregulation, or were the Commission proposing anything that relied in substantial regard upon the existence of competition, then I think we would have a much different analytic problem vis-a-vis the LECs.

But we are really not. We are assuming dominant carriers for purposes of this proposal. We are assuming market power is exercised by both AT&T and the LECs, and we are proposing a better form of regulation.

Now, as we have noted in our original order and in our latest order, there are some implementational issues that one has to deal with in the context of the LECs, questions of pooling and what have you, and we are dealing with them.

I don't think there is anything more substantive that would distinguish the LECs from AT&T generally with respect to the idea that animates this plan.

Senator BREAUX. I thank you, Mr. Chairman, and I thank you, Mr. Patrick, for your responses.

Senator INOUYE. Senator Gore.

Senator GORE. Thank you very much, Mr. Chairman.

I want to start by applauding your initiative and tenacity in taking on this particular subject. It is extremely complex.

I learned on the House Communications Subcommittee back in the 1970s about the complexities of these issues. I daresay there

are a lot of people in this room who remember the battles over SPF and SLU and all of the arcane subjects that took on tremendous importance and translated directly into dollars and cents for consumers and returns for shareholders.

All of that is to say that it is not easy to delve into these issues. They are extremely complicated, and I am glad that our Subcommittee is wading into this area.

But it is made more difficult, I would say, with all due respect, to our first witness here this morning by the fact that in my view, this proposal is not only complicated, but appears not to have yet been fully developed.

Mr. Patrick, you are candid in saying that you just do not have the information with which to respond to some of the questions you have heard this morning.

I want to know more about price caps. It is not just because I have a continuing skepticism over this particular Commission's zeal for deregulation. It is also because I want to be absolutely clear about the impact this plan would have on small, rural, independent, and co-op telephone companies, as several of my colleagues have mentioned already, and the potential for disturbing other values that might be threatened by such a dramatic change.

I think we have to recognize the need for full information and to move carefully here.

It is not good enough for me to simply be told that the FCC will take care of rural concerns, to pursue that example for a moment, because I have heard that before. During the post-divestiture period, small, rural companies had to fight tooth and nail, with the help of Congress and some on this Committee in particular, to obtain a modest fund to preserve universal service in high cost areas.

We have had repeatedly to obtain assurances that rural customers would not be subjected to long distance toll deaveraging, which would drive up rural telephone rates. I think that concern is again raised by this proposal.

So we cannot simply trust with blind faith the FCC to protect rural rate payers because the deregulatory zeal of this Commission has, in the past, made small telephone companies and their customers vulnerable, in my opinion.

I am not unalterably opposed to price caps. I have an open mind. But I have a lot of questions, as well.

Let me just pursue a couple of them. First of all, you believe this would be a good deal for rate payers, is that correct?

Mr. PATRICK. That is correct, Senator.

Senator GORE. Why is it voluntary, then?

Mr. PATRICK. It is voluntary because we are attempting to proceed in a very cautious way and because we have in mind in particular the interests of the rural telephone companies and the rural subscribers.

Senator GORE. Yes, but the voluntary nature of it—I mean, it is not voluntary for the consumers. It is voluntary for the service providers. If, in your view, this switch is beneficial to rate payers, then why do you give the option to the companies to choose it or not, depending upon whether it benefits them?

Mr. PATRICK. Well, Senator, that is an excellent question. As you know, being familiar with these issues and the complexities of the issues, there are always tradeoffs, and we are dealing with a number of tradeoffs in making this proposal.

What we had in mind when we proposed that we make this plan voluntary is a concern that the small telephone companies, in particular, might not be able to meet the productivity challenge in effect that we will propose for the other companies in the industry. We want that number to be a fairly aggressive number, that will insure that consumers are better off.

So we factored that in and made at least this initial proposal voluntary. We also think it is prudent to proceed in this fashion until we gain more experience with it.

Senator GORE. If I could interrupt you for just a second, your answer does not seem to address the question for this reason.

You seem to be responding with the assumption that the voluntary nature of it protects small rural companies by giving them the right not to participate. But, in fact, they are greatly affected by the choice by other companies to participate. Isn't that correct?

Mr. PATRICK. No, that is not correct.

May I just answer your first question, Senator?

Senator GORE. Yes, and then I will come back to my next question.

Mr. PATRICK. You made the observation that it is not voluntary for consumers, and that is correct. It is the carrier that has the option. But we believe that those carriers that stick with rate of return for whatever reasons, in this initial period, for instance, not believing that they can meet the productivity challenge, their consumers are going to be no worse off, and the consumers who are customers of carriers who elect rate caps we believe will be greatly benefited over time by the more positive incentive structure that exists.

My guarantee—what I have told the rural companies, and what we will do, is do what we can to make sure that they have an effective option to elect to take caps, if they want to; but, if they don't, that they will be no worse off. This goes to the issues that you identified earlier, the questions of high cost support, et cetera.

Senator GORE. Would it permit AT&T to deaverage its long distance rates?

Mr. PATRICK. No.

Senator GORE. It would not.

Would it give local companies discretion to set higher interconnection rates in rural areas than in urban areas?

Mr. PATRICK. No, Senator.

Senator GORE. Why would it not?

Mr. PATRICK. Because every tariff will be reviewed by the Commission, whether it is within the caps or bands or not. That, which you have just posed——

Senator GORE. With the same diligence that tariffs are now reviewed?

Mr. PATRICK. Oh, I would like to respond to that. But I first want to answer your question.

Senator GORE. Go ahead.

Mr. PATRICK. The answer to your question is—actually, I have forgotten the question.

Senator GORE. Then let me come back to it.

Would your plan accelerate the trend toward deaveraging by applying the plan to rates that local telephone companies charge long distance carriers that interconnect with local networks?

Mr. PATRICK. That's right. I'm sorry, Senator. I did forget your question because I was so upset by the remark.

Senator GORE. I can't believe you are this sensitive, Mr. Chairman.

Mr. PATRICK. Yes, and after all these years, isn't it incredible? After a year and a half, I'm still sensitive.

Senator GORE. And after all you have been through.

Mr. PATRICK. Yes, you are so right, Senator.

Senator GORE. I will try to remember that in my phrasing, from now on.

Mr. PATRICK. Yes—37 going on 62.

Geographic deaveraging—the rate cap proposal would not have the effect of increasing the incentive to deaverage.

As you know, the pressure to deaverage is a function of the fact, the simple fact, that some study areas or some areas of the country have higher costs than other areas. And so, there is that potential problem.

We have softened the incentive, tried to soften the incentive to deaverage, by our subsidy system, where we bring down the higher cost companies. But we have also flat-out said that the Commission is committed to geographic rate averaging, and nothing in the rate cap proposal would change that.

Your second question, the one I have not answered yet, is the interconnection.

Senator GORE. Yes.

Mr. PATRICK. The reason that would not take place is because that would be a violation of the Communications Act. For a company to discriminate between Company A and Company B in terms of the cost of interconnection would be——

Senator GORE. But what about between urban and rural areas, where you have large business customers who would want a preferable interconnection rate in urban areas?

Mr. WACK. Senator, are you talking about AT&T being charged different rates by a small company and a large company?

Senator GORE. Yes.

Mr. WACK. Last year, in the Unity 1–A proceeding, the Commission, working with the States, through the Joint Board process, adopted modifications to the current common line pooling rules. Those allow for a certain amount of flexibility, a series of transfer payments, and a series of long-term payments—all of it geared toward promoting universal service and protecting small companies.

The transfer payments that are involved and that will occur over the next five years, as we phase in the new system, will result in rate changes that are significantly larger by orders of magnitude than any that could occur as a result of price cap flexibility. Is there any flexibility provided to a carrier under caps that might

jiggle the urban-rural mix, I just don't see how the flexibility is there.

Senator GORE. But the small company safeguards in the Unity 1-A Agreement——

Mr. WACK. Are all preserved.

Senator GORE. Are they included in the proposed price cap regulation?

Mr. WACK. We didn't change the rules. They are the same rules we adopted last year, and the small companies supported those rules.

Mr. PATRICK. Senator, I said earlier that, had I to do it over, I would have done a very explicit discussion of those rules.

The reason they are not set forth and discussed in the price cap proposal is because the price cap proposal does not change those cost support rules or the level of support the small companies will receive.

You said earlier something about relying on the Commission's word. Well, in this regard, you don't have to. Those are in our rules.

Senator GORE. But aren't they based on cost of service?

Mr. PATRICK. Yes. The degree of subsidy, the amount of subsidy which a small, rural company gets is a function of the degree to which its costs vary from the national average.

Senator GORE. Well, it seems to me, if the safeguards are based on cost of service and you abandon that principle——

Mr. WACK. We have not abandoned costs of service.

Senator GORE.Then, over the longer term, support for those safeguards it seems to me erodes. Why is that not the case?

Mr. WACK. First of all, Senator, we have not abandoned cost of service in the price cap proceeding. It is all about costs, but it is about costs in a big picture sense.

Senator GORE. I understand that you are looking at the big picture. But we are trying to look here at some of the small pictures.

Mr. WACK. The small picture is that the transfer payments and the long-term support payments are all based on very technical evaluations of number of lines, what your average cost per line is. We are not going to abandon all those things.

All the companies, whether they are price cap companies or not, will have to maintain those records. Those records will be given to NECA under price caps as they are now. Calculations are very straight-forward and easy to do.

There is not any change.

Mr. PATRICK. Let me emphasize that point because that is a key point and I think it is responsive to your concern.

You are right that the price cap proposal involves not focusing in the tariff process as narrowly on the question of the relationship between costs and the price for a particular service. But this question of support for the rural carriers, as you correctly point out, is a question which involves costs and relative costs and transfers of subsidies.

We have explicitly provided in the order that we will continue to cause the carriers to provide and to file the data that is necessary for NECA to compute the levels of support that are due and owing to the small companies.

So we have thought of that and it is provided for. That is discussed in the proposal.

Senator GORE. If I may have just a little additional time, Mr. Chairman, I understand there are some at the Commission who believe that the price cap flexibility should apply only to AT&T. Is that correct or not?

Is there a discussion within the Commission?

Mr. PATRICK. If there is someone at the Commission who believes that, I want to know who it is.

Senator GORE. Fine. I just wanted to verify that. Some had expressed that concern.

Mr. PATRICK. Senator, let me answer your question seriously and say that the matter of relevance of competition is certainly one of the issues that has been discussed by a number of people at the Commission. I believe Commissioner Dennis raised this question and this may be what you are referring to. I believe she raised the question of how we should think about the distinction between AT&T and the LECs, the local exchange companies, in terms of competition. Whether or not she raised the question, it certainly has been an important issue discussed at the Commission, and is expressly address in the further notice.

Senator GORE. But there is no intent to exclude the BOCs if you adopt the plan?

Mr. PATRICK. No, sir.

Senator GORE. Now, the cap would be on current rates, correct?

Mr. PATRICK. We have proposed to initiate the proceeding based upon current rates. That is correct.

Senator GORE. Current rates are not all equal in their assumed legitimacy. Their documentation, the level of review—I mean, some of them are just outrageous and only remain on the books because you have not gotten around to dealing with them yet.

Would you lock in those along with the rates that have been thoroughly reviewed and analyzed?

Mr. PATRICK. No, sir. That is a very good point. It is one that we have thought quite a bit about.

The answer to your question is no.

What we have proposed is that if an investigation with respect to a rate is continuing at the time price caps were implemented—and, as I mentioned earlier, under the rosiest of scenarios, that would be in the spring of 1989—if there were an investigation continuing, that cap would be subject to that investigation and the Commission would adjust the cap, the prices, accordingly, upon the conclusion of that investigation.

Thus we have a number of investigations pending with respect to rates at any given point in time, and the rate cap proposal would involve no alteration of that fact.

Senator GORE. Well, isn't it true that under the current rate of return system, the prices have been going steadily down?

Mr. PATRICK. Well, it depends on the prices you are talking about.

Generally, interstate rates, which is what people have discussed for the most part, have seen a precipitous decline since divestiture, about 35 percent, and that is owing mostly to two things. One is competition. The second—probably in terms of percentages this is

most important—is the flow-through of access charge reductions to the customers of the inter-exchange carriers. As access charges for the inter-exchange carriers went down due to our subscriber line charge program, we required that they be flowed through. And we would continue to require those sorts of flow-throughs.

Senator GORE. Well, of course, that is a separate argument. At the time, I told you you were going to get these local bypass problems, which the Commission said did not exist, and you very eloquently described the emergence of that very local bypass problem a moment ago.

Just one final question here. Well, the penultimate question is this. Doesn't it increase the potential for predatory pricing in those areas of service where there is not competition, and the effective reduction only in the areas where there is competition?

I mean, you have that problem already. Does this not exacerbate that?

Mr. PATRICK. I don't think so, Senator, because we have, as you know, provided for not only a cap on a certain basket of services, but banding limitations on the degree to which service rates within that basket can go up or down. On the predation side, there is a limitation on a reduction of 5 percent. Any proposed reduction beyond that would be subject to a full tariff review, and the issue would be essentially the issue that we have today. Is this a matter of predation? Does it cover the relevant costs, et cetera?

In fact, one can argue, as I often do, that, in general, a cap system is more effective in terms of combating predation because predation is only a rational strategy if you can recoup the losses that you have to suffer during the time that you are predating; and, if we cap prices over here (indicating), it is not clear that you are going to be able to so recoup your costs.

Senator GORE. Well, if your competition is eliminated, you have a fair assumption that you will be able to.

Mr. PATRICK. But you are still dealing with a cap even if you turned right around and eliminated your competition. We are not worried about competition.

Senator GORE. But additional increases are allowed above and beyond the cap, too, right?

Mr. PATRICK. Only after an extraordinary showing, which we can talk about. As a matter of law, as a matter of the statute——

Senator GORE. How many lawyers does it take for an extraordinary showing?

Mr. PATRICK. It takes a whole lot of them.

But, unfortunately, we have a lot of them in the city. As you know, because you gave me the statute to live with—actually, you did not, but this institution did—the Communications Act provides that a carrier has a right not to suffer confiscation. So, therefore, we cannot, as a matter of law, simply announce that this is the cap and it cannot be penetrated.

But the showing to go above the cap would, as I say, have to be a fairly weighty showing.

Senator GORE. I appreciate the extra time, Mr. Chairman.

I would say that in closing, I think the Commission has a burden to carry on this proposal that is heavier than normal. As I said earlier, I have an open mind about it. A lot of the questions that I

have been pursuing need further exploration. We need to know more about what the impact would be.

Frankly, in the current environment, when we are looking at a transition of one kind or another, in January, with a new beginning, it seems to me that the burden you need to carry in providing answers to these questions is a significant one.

Rate of return regulation has been accompanied by steady declines in prices paid by the consumer. Technological improvements that have come out of this unprecedented scientific revolution that is continuing to accelerate have produced benefits that are passed along.

Under this proposed new system, it is not clear to me that that would continue. Again, I have an open mind. But I think that the burden has not yet been met.

I hope you don't just rush into this without giving due attention to this because we are going to be following it extremely close.

Thank you, Mr. Chairman.

Senator INOUYE. Thank you very much.

Senator Ford.

Senator FORD. Thank you, Mr. Chairman. I apologize for being late. I had to chair another hearing earlier, and I won't get into my questions since you have had these gentlemen for about two hours, now, I think.

I am not opposed to large companies making money. But I certainly don't want their foot to be placed on some of my small operators out there. I will be watching this very closely, and I will take the time, Mr. Chairman, to read the transcript of this hearing.

Thank you for the opportunity.

Senator INOUYE. Thank you very much.

Senator Wilson.

Senator WILSON. Thank you, Mr. Chairman.

As I understand it, Senator Gore has already asked the question which I had about the applicability of the caps to the RBOCs as well as to AT&T.

So I will simply read the record and thank you.

Senator INOUYE. Thank you.

Mr. Chairman, I am certain you have noted that every Member of the Subcommittee has been present. In fact, this is the first time you've seen all of us.

Mr. PATRICK. Certainly the first time I have seen all of them, Mr. Chairman.

Senator INOUYE. Under your plan, should, or would, the Commission monitor the rate of return?

Mr. PATRICK. In general terms, yes, Senator.

The initial tariff review of tariffs that are within the cap and band restraints would focus on just that, whether they were under the cap and within the bands.

But—and I think this is a very important addition to the proposal that we made, frankly, in response to concerns that were expressed by a number of Members of Congress—we have proposed in this further notice that we continue to collect data with respect to costs that will allow us to assess what is going on in terms of rate of return. I think very importantly, that the further notice will allow us to assess what the situation is at any point in time if we

receive a complaint, and at the time we conduct our periodic review. At that time, we would look at everything, including rate of return.

Senator INOUYE. Is there some level of return that you would consider to be excessive, and if they reached that level, would you intervene?

Mr. PATRICK. The Commission has not reached that question. So, no, we have made no judgment on that.

The level of return that was being earned at the time we conducted a review would be a relevant piece of evidence, and, if it were very high, I think we would be pleased in one sense. We would be pleased in the sense that the carriers would then have revealed to us just exactly how efficient they can be, and it would allow us to adjust the base of rates downward, or to adjust the formula, so that more of those benefits are captured for consumers.

The other circumstance in which we would be concerned about a high rate of return is that anyone, at any time, has a right to file a complaint, contesting that a particular proposed tariff is unreasonably high. We would have to look at it at that time.

We propose to retain the data to put us in a position to do that.

Senator INOUYE. What level, would you consider to be "unreasonably high?"

Mr. PATRICK. Well, at this point in time, we have determined that a fair rate of return is about 12 percent for the LECs and 12.2 percent for AT&T. What is reasonable beyond that in a different environment would be a different question.

It is critical in this discussion of what an unreasonable rate of return is to recall that this program will cause both consumers and the carriers, or at least the efficient carriers, to be better off. This is to say that if we adjust the rates in a downward direction by an amount that is greater than the productivity improvement that we would expect under rate of return—which is what we will do—consumers will be better off, even while some of the most efficient carriers are earning a little bit more in the way of entrepreneurial profits.

At the time of the review, we would evaluate what was happening in terms of rate of return and make an appropriate adjustment, recapturing even more of those benefits for consumers.

Senator INOUYE. Senator Breaux, do you have any further questions?

Senator BREAUX. Just one.

If we have a price cap, how does the Commission insure the quality of service to the consumer?

Mr. PATRICK. I am glad you asked me that, Senator, because it is an important concern that has been expressed.

The first thing that I would say is that some of the problems that we have had with quality of service are problems that we have suffered under a rate of return environment. For instance, there are the problems we had with quality and levels of service that we suffered immediately post-divestiture.

But I think that we can continue to insure a high level of quality service being provided for a number of reasons.

First of all, the incentive to be efficient, which would result from caps, is not inconsistent with quality. In fact, in the telecommuni-

cations industry, reducing quality often increases your cost. The reasons for that are pretty obvious.

This is a technology-intensive industry, and, if you have to get human beings involved, calling people who are making complaints, going out to check why a switch is malfunctioning in some regard, that dramatically increases your costs.

The second reason I do not think caps and quality are inconsistent is because efficient technology, the sort of technology we would expect carriers to deploy, is often very high quality technology. I am thinking here of moving from mechanical to digital switches, or deploying fiber optics.

Secondly, quality is a term of the competition for AT&T and, to the extent the local exchange carriers are worried about bypass and some of the other scenarios that we spoke of earlier, quality is an issue that they have to think about in those terms.

Thirdly, we monitor quality. We have a number of indicia of the quality of service that are provided to the Commission on a regular basis—customer satisfaction; we disaggregate the data for consumers and for businesses, et cetera. So we monitor quality, and that would allow us to act if there were a problem.

It is that monitoring program which really corrected, or helped to correct, the quality problems that we suffered post-divestiture.

We also retain section 214 authority, which is the authority to approve construction. At that time, we have occasion to evaluate the type of investment that is being made.

Lastly, I would note that Bryan Carsberg, the Director General of OFTEL, has noted that, after their first several years of the price cap plan in Great Britain, they note the highest level of investment in high quality equipment that they have ever seen by BT. So I think that is a little bit in the way of empirical data.

Senator BREAUX. Thank you, Mr. Chairman.

Senator INOUYE. Senator Gore.

Senator GORE. One other question.

If an LEC opts for price caps under the plan, what happens specifically to that company's participation in the pooling arrangements that support high cost service?

Mr. WACK. Nothing, Senator.

The common line part of our price cap program does not begin until two years from now, in July of 1990. The depooling, the modifications, will be implemented pursuant to rate of return regulation in the spring of 1989. So we'll have a whole year of experience, 15 months, with their tariffs under the old system, and then we will bring those tariffs under the price cap regime.

Senator GORE. It will be based on rate of return. But, if they leave the rate of return system, then you will base it on the historical experiences, did you say?

Mr. WACK. No. Under the rules, the transfer payments are all based on base year 1988—this year. So it does not make any difference.

Senator GORE. Are you telling me that if an LEC opts for price caps, there will be no effect at all on the company's participation in the pool to support high cost service?

Mr. WACK. I don't see how there could be.

No.

Senator GORE. Thank you.

Senator INOUYE. Chairman Patrick, whether we agree or disagree with you, I must say that your presentation and your responses have been persuasive, articulate, and very impressive.

I can assure you that Members of this Subcommittee will be studying this matter very closely, and we will be communicating with you further.

I have just one question.

What effect would it have to delay this proceeding, to expand the comment period, for example? Would it have any detrimental effect upon the industry or rates, et cetera?

Mr. PATRICK. Well, Mr. Chairman, I suppose reasonable minds can differ about this, and I am sure they will. But I believe that it would have a detrimental effect on consumers because I believe that what we would delay and what we would forego are dollars in the pockets of consumers.

We have estimated that this plan will result in $1.6 billion in rate reductions that would not occur but for our adoption of a rate cap proposal. So it is just a question of when we start with a program that will realize those sorts of immediate benefits for consumers. That is number one.

Number two, and maybe in the long run more importantly, is to put into place a system that I believe will result in even more dramatic gains for consumers in the long run.

Senator INOUYE. Under your present schedule, when do you hope to issue your plan?

Mr. PATRICK. Mr. Chairman, it depends on the comments and the evaluation of the comments. We have suggested in the further notice that in no event could price cap tariffs take effect earlier than the spring of next year, 1989. When the Commission will be in a position to adopt an order is a function of the information we receive in the docket, and the comments have not even closed yet.

I will not move forward with caps unless I believe there is an adequate record to support the proposition and our belief, our presumptive belief, that consumers will benefit.

Whether we have that record will have to await the comments.

Senator INOUYE. Chairman Patrick, I thank you very much, sir.

Mr. PATRICK. Thank you, Mr. Chairman.

[The statement and questions and answers follow:]

STATEMENT OF DENNIS R. PATRICK, CHAIRMAN, FEDERAL COMMUNICATIONS COMMISSION

Good morning Mr. Chairman and Members of the Subcommittee. I welcome the opportunity to appear before you today to discuss the Commission's proposed reform in the area of dominant carrier regulation: the "price cap" proceeding.

I would like to begin by underscoring the substantial policy agreement that I believe exists between the Commission and the Members of this Subcommittee concerning the regulation of dominant carriers in general, and the price cap proceeding in particular. We recognize that regulation is necessary to protect consumers from the potential that dominant carriers would employ their market power in ways harmful to consumers and the public interest. Therefore, the price cap proceeding is not a vehicle for abandoning regulation.

Instead, we have undertaken a frank and fair appraisal of our current methods of regulating dominant carriers, an evaluation of whether they are the best available means of enhancing consumer welfare and promoting the public interest. We have asked ourselves whether our current approaches actually conform to the realities of the age of information and growing competitiveness; whether they are helping to improve the competitiveness of American industry in domestic and international markets; and, most importantly, whether they are well suited to ensuring that consumers share in the benefits of this new age through lower rates and a wide array of high quality services.

As many have long suggested, and as the Commission demonstrates in its May 1988 Further Notice of Proposed Rulemaking, there is no serious dispute that existing regulatory methods -- which are built on the concept of directly limiting a carrier's rate of return on investment -- do not fare well under such an evaluation. It is no wonder then that there is widespread agreement about the need to adopt more forward-looking regulatory approaches, ones that are sturdy enough to withstand the rapid changes the telecommunications industry is sure to experience as we move into the next century.

Evidence of this agreement can be found in the large number of states that either have implemented alternative regulatory systems already or are seriously contemplating doing so, and in the United Kingdom, where incentive regulation has been in effect since 1984 with great success. Some of these alternatives are of limited scope, others are more comprehensive. They go by many different names. Some are called "rate stability plans" or "social contracts." The British call their system "price caps."

But a common thread runs throughout these alternatives -- in each instance, regulators are taking notice of the perverse incentives, injurious to the public interest, which are created by rate-of-return regulation. And they are attempting to fashion systems that replicate more accurately than

existing regulation ever could the consumer welfare-enhancing incentives that are at the core of the competitive process.

In theory, rate-of-return regulation is intended to emulate the operation of a competitive market, and to secure for consumers the benefits they would derive from competition. However, there are many differences in the ways rate-of-return regulation and competitive forces actually operate and, consequently, they create different incentives. For example, firms in a competitive market strive to maximize profits by becoming more efficient, innovating, and providing high quality service. This dynamic process is not replicated under rate-of-return regulation. Indeed, rather than encourage efficient and socially beneficial behavior by the regulated firm, rate-of-return regulation actually discourages it.

The distorted incentives created by rate-of-return regulation are easily illustrated. Although carriers are limited to earning a particular percentage return on investment under rate of return, a carrier seeking to increase the amount of its dollar earnings can do so merely by increasing its aggregate investment. In other words, its earnings go up if its investment goes up. This creates a powerful incentive for carriers to "pad" their costs, regardless of whether additional investment is necessary, efficient, or responsive to consumers' desires. And because a carrier's operating expenses generally are recovered from ratepayers on a dollar for dollar basis, and do not affect shareholder profits, management has little incentive to conserve on such expenses. This establishes an additional incentive to operate inefficiently.

And when and where competition emerges, rate-of-return regulation gives carriers the incentive to assign costs from competitive services to less competitive services -- injuring both the evolution of fair competition and the ratepayers who are forced to bear costs unrelated to the services they receive. Moreover, rate of return creates few incentives to innovate in the provision of service or to deploy new services. The result of all this is that the Commission spends countless hours and millions of taxpayer dollars trying to prevent carriers from following incentives we helped to create.

Price cap regulation represents an attractive alternative to existing regulation. It protects ratepayers from the exercise of market power more directly than rate of return and creates the consumer-oriented incentive system that obtains in a competitive market. Under caps, our regulatory approach would facilitate, not fight, our public interest goals.

Caps do this by placing limits on the rates carriers may charge for their services. In the face of such constraints, a carrier's profit levels become directly tied to its management of underlying costs and its responsiveness to consumer demand. In essense, under price caps the regulated firm is encouraged to do well by doing good. Carriers that become more efficient and deliver high quality service would see their profits rise. Carriers that fail to become more efficient or maintain high quality service would see their

profits fall. In short, a carrier is told: here is a mark. Beat it, and you may keep the additional profit for awhile. After the fourth year of the plan, the mark will be adjusted in light of the information produced by the incentives price cap regulation provides about carriers' capabilities.

Under price caps, cost padding and cross-subsidization would not lead to higher profits, so the incentives to engage in such activity are limited. Carriers also have the incentive to innovate because, quite simply, they can earn more money by doing so. The system also is less complex to administer than rate-of-return regulation and, in the long run, this should reduce the cost of regulation. Most importantly, price cap regulation can be implemented in a manner ensuring that consumers share immediately and directly in the benefits of the improved incentives this form of regulation likely will engender. Indeed, under our plan, consumers immediately will enjoy rates below those we would anticipate under rate of return, and will secure the benefits of lower rates on an ongoing basis as improved price cap incentives spur a more efficient, lower cost industry organization.

In an August 1987 Notice of Proposed Rulemaking, the Commission laid out a framework for price cap regulation and requested comment from interested parties about fleshing out this framework. More than 6,000 pages of pleadings were filed in response, incorporating the ideas and suggestions of consumers organizations, user groups, carriers, industry trade groups, and governmental entities with substantial experience in telecommunication regulation.

With few exceptions, the comments reflect a fairly broad consensus that the deficiencies of existing regulation are real and warrant correction, and that a properly structured price cap plan would correct these deficiencies. The record also contains numerous proposals on particular issues relating to the initiation of price cap regulation and its on-going administration. Some of these proposals call for radical changes in existing procedures.

I am not persuaded price cap regulation needs to be radically different from rate of return in order to be effective. Both approaches represent full regulation, and both are designed to ensure that rates are based on the cost of providing service. As it now should be clear, price cap regulation is not profit deregulation. In fact, relatively modest changes in existing procedures appear to be all that is required to substantially reduce the distorted incentives created by existing regulation and replace them with more efficient, consumer-oriented incentives.

Mr. Chairman, the Commission carefully analyzed the voluminous record accumulated in response to the initial price cap Notice and has developed a specific plan for translating price cap theories into an operational regulatory system. The rationale underlying this plan and its specific details are contained in the Further Notice of Proposed Rulemaking I mentioned earlier. Much has been made of the fact that this Further Notice is some 350 pages long. I am surprised that the Commission is being criticized for doing a thorough job, but I am happy to accept criticism of this nature. By way

of comparison, I want to point out to the Subcommittee that it is not unusual for the annual access tariff filing of a single local exchange carrier to be two or three times the size of the Further Notice, so it should not be a matter of concern that the explanation of the rationale for price caps is more than a few pages long.

The detailed proposal we put forth in the Further Notice shares the same philosophical approach as alternative regulatory systems already in effect in the states and Great Britain, and it adopts many of their technical aspects. The fundamentals of the plan are as follows:

- Price cap regulation will be implemented initially on a voluntary basis. This aspect of the plan reflects our cautious approach to implementing alternative regulation and provides a means of avoiding any unforeseeable difficulties price cap regulation might present, particularly for smaller telephone companies.

- In general, caps would be applied to all of a carrier's existing services. Such application ensures the greatest amount of consumer benefit and protection from price cap regulation. Existing rates have been thoroughly scrutinized in the tariff review process and represent the best and most practical place to initiate the new system. Nothing in the plan prevents the Commission from ordering appropriate adjustments, including refunds if warranted, in the event that a rate subject to investigation is found to be unlawful after the initiation of price cap regulation.

- Rates would be adjusted each year pursuant to a predetermined formula in order to ensure that they comport with the statutory requirement of being based on the cost of providing service. This formula reflects economy-wide cost changes measured by the Gross National Product Price Index (GNP-PI), a recognized, government-administered index that reflects cost changes experienced by dominant carriers more accurately than the more commonly known Consumer Price Index. Rates also would be adjusted for known cost factors beyond a carrier's direct control, such as changes in tax laws, jurisdictional separations, and the Uniform System of Accounts. If AT&T elects price caps, its rates would be adjusted to reflect changes in access charges, as is the case today.

- Although the GNP-PI already reflects productivity gains for the economy as a whole, it does not reflect the degree of productivity gains experienced by the telecommunications industry historically. For the entire telephone industry, the long term productivity factor -- the reduction in telephone rates relative to the general price level in the economy -- was about 2.1 percent. This number is the starting point for any analysis of carrier productivity. Record evidence focusing on the past several decades, including the Common Carrier Bureau's own examination of AT&T's productivity in

the post-divestiture period, indicates that carriers have experienced approximately 2.5 percent annual productivity gain beyond that experienced economy-wide. Therefore, we will require carriers to adjust their rates downward each year by 2.5 percent, thus ensuring that consumers will be as well off under caps as they likely would have been under rate of return.

- Because our goal is to make consumers better off under price caps than they likely would be if we continued rate-of-return regulation, our plan requires carriers to meet goals that exceed the historic productivity of the telephone industry. In addition to the 2.5 percent adjustment noted above, carriers would be required to lower rates by another 0.5 percent -- an amount we refer to as the Consumer Productivity Dividend -- in order to ensure that consumers receive a guaranteed, up-front share of the additional efficiencies flowing from the improved incentives created by price cap regulation. We estimate that the Consumer Productivity Dividend would bring consumers $1.6 billion worth of rate reductions over four years over and above what they would receive if we continued existing regulation.

- In addition to lower rates, consumers would receive an additional measure of improved protection under caps in the form of rate stability. We propose to apply banding limitations of plus or minus five percent to service rates in order to limit the degree of potential price change each year.

The Commission's proposal to implement price cap regulation through the tariffing process largely eliminates the need to make wholesale revisions in our existing Rules. Our proposal merely adjusts these Rules so they accommodate the alternative system, leaving the underlying rules undisturbed and fully available for use in regulating carriers that do not elect price cap regulation. In order to ensure that our proposal does not disturb telecommunications regulation by the states, no changes will be made to current separations rules or procedures.

Mr. Chairman, during the period when the Commission was evaluating the record accumulated in response to the August 1987 Notice of Proposed Rulemaking, I made some promises to Members of this Subcommittee and other Members of Congress about the manner in which the Commission would propose to implement this alternative system. The short list of the fundamentals of our proposal I just reviewed demonstrates that I have kept my commitment that price cap regulation can be implemented in a cautious and relatively simple fashion, and that it is neither as complex nor as radical as some commenters would have this Subcommittee believe. I also made four additional promises, and with your permission I want to take a few moments explaining how I have made good on my commitments:

First, our proposal presents no threat to policies and programs designed to benefit low-income households or rural America, such as the Link-Up America program and geographically averaged long distance rates. Indeed, the Commission also has taken special care to ensure that the proposal does not adversely affect the small telephone companies that provide service in much of rural America. No small company will be forced to participate in price cap regulation because it is elective. The proposal preserves existing pooling mechanisms and support payments that are critical to promoting universal service. It does not intentionally disturb the Commission's practice of prescribing a unitary rate of return for local exchange carriers.

Second, our proposal is structured to ensure the continuation of the high quality telephone service Americans currently enjoy. We are proposing to retain all existing Commission procedures and reporting requirements relating to the monitoring of service quality, and the Further Notice requests specific suggestions about how these procedures and reporting requirements can be strengthened.

It also is important to note as a general matter that many forces constrain a carrier's ability to boost its profits by degrading the quality of service. Cutting back on quality does not necessarily increase profits because permitting the network to deteriorate would result in larger blocking percentages, poorer transmission clarity, and longer down-time for switches and lines -- all of which ultimately reduce the number of completed calls and, therefore, a carrier's revenues. A second practical restraint is that quality declines manifest themselves readily. No customer needs special training to detect an increase in busy signals, wrong numbers, or static on the line. And as the Commission demonstrated in the post-divestiture period when such complaints were made, we have a track record of responding swiftly and effectively to customer complaints about quality. A third restraint is that competition in the long distance market has turned quality into an important selling point, indicating that AT&T could permit quality to decline only at peril to its market position. We believe that the combination of these practical restraints, and our ongoing monitoring efforts, will assure that quality of service does not decline under price cap regulation.

Mr. Chairman, my third promise was that our price cap proposal would not disturb the Commission's commitment to fostering competition and preventing discrimination in the provision of telecommunications services. We have sought to satisfy this commitment through the implementation of such policies as open entry, equal access, resale and shared use, freedom of interconnection, the unbundling of tariffed services, and the non-structural safeguards under development in our Computer III rulemaking. We shall retain these policies under price caps and continue to enforce them vigorously.

My fourth and most important promise to this Subcommittee was that the price cap plan would put consumers in a better position than they are today. I believe we have satisfied this promise. Application of the Consumer Productivity Dividend ensures that rates under price cap regulation likely

will be lower than they would be if we continued existing regulation. As noted above, we estimate a $1.6 billion savings for consumers resulting from the so-called CPD. The banding limitations on rate changes guarantee to consumers greater rate stability and predictability than they currently enjoy. The proposal also should greatly strengthen carriers' incentives to act in ways that redound to consumers' benefit -- by offering a wide array of high quality services at cost-effective rates.

Mr. Chairman, as technological advances in the telecommunications industry speed us toward the next century, I believe government has a responsibility to explore new solutions to regulatory problems and to adopt policies aimed at promoting long-term benefits to society. The price cap plan detailed in the Further Notice represents the Commission's best effort to meet this challenge. It is improved regulation, informed by our experience over the last fifty years, and adapted to meet the realities of the modern telecommunications marketplace. It represents an opportunity to make both consumers and the industry better off by eliminating the inefficiencies and distorted incentives brought about by an outmoded form of regulation.

I state without apology that price caps proposal is likely to achieve this result because it places increased reliance on market-oriented incentives. I am well aware that 1988 is a Presidential election year, and many are saying that market-oriented economics may no longer be in vogue. But the FCC's history of relying on such economics and competitive market forces stretches back to the 1950s, and I predict that future Commissions will continue this tradition, not because of any party platform or passing political fancy, but because competition works. It embraces and exploits technological advances in ways that promote consumer welfare and the public interest.

I also am well aware that there are people who differ with the Commission about various aspects of our price cap proposal. All of us at the Commission are anxious to engage in a constructive dialogue -- to listen and learn -- to improve it. In crafting the Further Notice, we have sought to incorporate the thoughts and suggestions of Members of this Subcommittee and others in Congress.

We clearly have responded to the request by Senator Kerry and other Members of Congress to provide more information about the price cap approach to regulation and the way we propose to implement it. As I mentioned previously, the Further Notice of Proposed Rulemaking provides ample notice and explanation of exactly what is wrong with current regulation, what we propose to do about it, why our proposal should be preferred over alternative approaches -- and, most importantly, how our proposal will make consumers better off than if we remain with the current system.

Mr. Chairman, the Commission has not and will not rush to judgment in the price cap proceeding. However, if our proposal meets the requirements I have outlined above -- principally that it makes consumers better off than they otherwise would be -- then the benefits of alternative regulation should not be delayed because it is an election year. The debate will be vigorous, as it should be. But let us resolve to make it a constructive debate.

QUESTIONS OF SENATOR PRESSLER AND THE ANSWERS THERETO

Question #1: Can you explain the relationship among depooling, price caps, and maintaining average rates?

Answer: The common line pooling system is an important Commission program operating to ensure the continuation of geographically averaged long distance rates. Implementing the price cap proposal adopted by the Commission in its May 1988 Further Notice of Proposed Rulemaking would not disturb the ongoing administration of the common line pooling system or the implementation of pooling modifications that is scheduled to begin in 1989. Therefore, price cap implementation presents no threat to the continuation of geographic rate averaging. The separate relationships between price caps and each of the aforementioned subjects -- ongoing pool administration and pooling modifications --are discussed below.

ONGOING POOL ADMINISTRATION:

The Commission's common line pooling rules help ensure averaged rates by limiting the disparity in "carrier common line" (CCL) charges paid by interexchange carriers (IXCs) to local exchange carriers (LECs). Pooling also provides small telephone companies and their subscribers with additional benefits that promote universal service. All of these benefits would be preserved if the Commission's price cap proposal were adopted because the proposal would not change existing rules and procedures governing the pooling process. These benefits, and a technical explanation of how pooling works, are discussed below.

Pursuant to the dual system of federal and state regulation of telecommunications established by Congress under the Communications Act of 1934, local telephone company costs are allocated between the state and interstate jurisdictions and then recovered according to applicable federal and state regulatory policies. Telephone companies "book" their costs in accordance with the Commission's Uniform System of Accounts (USOA), and then allocate such costs between the state and Federal jurisdictions according to the terms of the so-called "Separations Manual." The USOA and Separations Manual are incorporated into Parts 32 and 36, repectively, of the Commission's Rules.

A major portion of local telephone company costs are associated with what are commonly known as "local loops," that is, the equipment connecting each subscriber's premises with the local telephone company switch. These costs vary, often significantly, from telephone company to telephone company, and there are large differences in the interstate allocation of these costs.

Loop costs allocated to the interstate jurisdiction become part of a company's "common line" revenue requirement. Although loop costs comprise the major portion of this revenue requirement, it also includes, on a transitional

basis, costs associated with embedded inside wire and depreciation reserve deficiencies. Embedded inside wire and depreciation reserve deficiencies are being phased out of local telephone company rate bases pursuant to Commission decisions to deregulate the provision of inside wiring and to permit telephone companies to amortize certain depreciation reserve deficiencies.

Local telephone companies recover almost all of their interstate common line revenue requirement (جوز, costs) through two separate charges: (1) subscriber line charges, which are flat-rate charges assessed on end users each month; and (2) the carrier common line (CCL) charge, which is a usage charge assessed on interexchange carriers on a per minute basis. With one minor exception, all common line costs not recovered through subscriber line charges are recovered through the CCL charge paid by interexchange carriers. Thus, the higher the amount of common line costs recovered through subscriber line charges, the lower the CCL charge will be.

When the access charge system was implemented in 1984, the $1.00 ceiling on residential and single-line business subscriber line charges left the bulk of common line costs to be recovered from interexchange carriers through the CCL charge. As noted above, common line cost recovery needs vary widely among telephone companies, and their CCL rates would have differed significantly in the absence of some pooling mechanism, particularly in rural and other low density study areas, where costs tend to be much higher than the national average. The prospect that CCL charges would vary widely among local telephone companies generated concerns that interexchange carriers might deaverage their rates in response to these differences, and that telephone companies with very high CCL charges would be especially susceptible to bypass. If either of these prospects actually occurred, residential and small business subscribers in high cost areas would be forced to shoulder inordinately high common line cost recovery burdens as a result of sharply increased long distance rates.

In light of the concerns, the Commission's access charge plan required all local telephone companies to participate in a common line tariff and pooling arrangement, administered by the National Exchange Carrier Association (NECA). The pooling of costs and revenues permitted all LECs to tariff a uniform CCL charge, thus eliminating the significant disparities among such charges that would have existed if each LEC based its CCL charge on its own costs.

The common line pooling system has proven to be an effective means of ensuring the continution of geographically averaged long distance rates. Moreover, the common line pooling system, together with other pools created by the Commission and administered by NECA in accordance with Commission rules, also provides several other benefits to small telephone companies and their subscribers. Pooling eliminates direct tariff filing burdens on small companies, reduces their operating risks substantially, and greatly increases their ability to achieve a steady interstate rate of return on investment. All of these benefits ultimately redound to subscribers because such benefits

help to ensure that telephone service is available at reasonable rates. Thus, in addition to supporting rate averaging, pooling promotes the important goal of universal service in many different ways.

No commenter in the price cap proceeding offered detailed suggestions about how the benefits of price cap regulation could be obtained in an environment in which telephone companies pool costs and revenues, and share operating risks. The Commission concluded, therefore, that obtaining these benefits would require fundamental alterations to the purposes, structure, and operation of the pools, or the elimination of pooling. Confronted with the choice between price cap implementation and continuing policies that serve small companies and their subscribers, the Commission chose the latter. This choice was explained in the Further Notice:

> The primary goal of this proceeding -- establishing regulatory methods that benefit consumers by directing efficient dominant carrier operations -- responds to just one aspect of our mandate under the Communications Act to regulate in the public interest. This goal must give way when, as here, it appears to conflict with programs and policies developed over many years to further our goal of achieving universal service. We conclude, therefore, that our current pooling rules and procedures will not be altered by the policies proposed in this proceeding, and that we will continue to regulate such pools pursuant to traditional rate-of-return principles.

In accordance with this decision, the Commission is not proposing any changes to existing rules and procedures governing the pooling process, including the rules governing transitional and long-term support payments which were adopted last year by the Commission, after consultation with the states through the Joint Board process, in the so-called Unity 1-A proceeding. The Commission also is not proposing to change rules and procedures commonly associated with the pooling process or necessary to assure that the pools can continue to be administered effectively, such as the Uniform System of Accounts (USOA) and current jurisdictional separations rules. In addition, the Commission is not proposing to change the rules governing the administration of the High Cost Fund support program, including the rule amendments adopted last year that targeted more support for small telephone companies.

POOLING MODIFICATIONS:

The Commission's price cap proposal, in addition to being crafted in a way that does not disturb the ongoing administration of the common line pool, also is structured to ensure the smooth implementation of pooling modifications scheduled to occur in 1989. These modifications, and their relationship to the price cap proposal, are discussed below.

When the Commission adopted the current pooling arrangement, it recognized that the effects of pooling are not entirely beneficial. For example, a nationwide pooling system sharply reduces each telephone company's incentives to reduce its costs -- and, consequently, its rates -- because the benefits of such reductions must be shared with all members of the pool. Indeed, pooling permits a telephone company to "export" its cost increases because such increases are spread to other pool participants. Moreover, forcing all telephone companies to charge a nationwide averaged CCL rate exacerbates uneconomic bypass incentives in study areas with lower than average common line costs. The requirement that a uniform CCL rate be charged in all study areas also reduces a telephone company's flexibility in preparing its interstate access tariffs. These non-beneficial byproducts of pooling generate tangible costs for telephone companies and ratepayers alike. For instance, one investor service lowered the bond rating of the New Jersey Bell Telephone Company in 1987 partly because the high CCL rate it must charge as a result of current federal regulatory policies, including mandatory common line pooling, encourage bypass activity.

In 1987, the Commission determined that substantial public interest benefits would be obtained if its rules governing the common line pooling system were modified to permit carriers the option of withdrawing from the NECA common line tariff and basing their rates on their own costs of service. Working with the states through the Joint Board process from 1986 through 1987, the Commission adopted modifications designed to provide this option to carriers without threatening the continuation of rate averaging or diminishing the many administrative benefits pooling provides to small telephone companies. These modifications included a series of modest increases in the residential and single-line business subscriber line charge, up to a ceiling of $3.50 as of April 1989, which were required in order to ensure that depooled LEC CCL rates would not threaten the continuation of geographically averaged long distance rates. LEC tariffs implementing these modifications are scheduled to take effect on April 1, 1989.

April 1, 1989 also is the date on which the Commission is proposing to begin implementing price cap regulation, including the application of such regulation to certain LEC rates. However, the proposal explicitly defers application of such regulation to LEC common line rates until July 1990. This fifteen month delay serves two purposes. First, it avoids the possibility that an attempt to implement price cap regulation and pooling modifications on the same schedule might unintentionally disrupt the smooth implementation of either policy. Second, the fifteen months will provide users, carriers, and this Commission a reasonable amount of operating experience with company-specific common line rates before using them to establish the indices that govern permissible rate changes under price cap regulation.

Question #2: Do you think price caps should remain voluntary following the four-year trial period, or should they then be made mandatory for all telephone companies if the trial has been successful?

Answer: It would be premature to reach any conclusions about making price caps mandatory for all dominant carriers prior to the completion of the comprehensive performance review of the price cap program, which is scheduled to begin three years after the initiation of such regulation. The Commission's current primary proposal is to permit carriers to elect price cap regulation initially. The Commission also is seeking comment on an alternative proposal, pursuant to which price cap regulation would be mandatory for AT&T and all large LECs, while remaining optional for small telephone companies. The record accumulated in the comprehensive performance review will put the Commission in a better position to consider whether price caps should be mandatory for all dominant carriers.

It bears emphasizing, however, that the Commission's current proposal to permit carriers to elect price cap regulation initially reflects our long-standing practice of taking special care to craft policies and rules that accommodate the unique concerns and characteristics of small telephone companies. For example, under our proposal, carriers are required to lower prices so as to reflect predetermined productivity levels each year in order to qualify for streamlined tariff review procedures. The productivity requirement is set at an aggressive level in order to ensure consumers a fair share of the increased efficiencies price cap regulation will generate. Based on our long-standing recognition that small carriers generally do not have as many opportunities as larger carriers to achieve efficiencies, however, we were concerned that the application of the productivity requirement to small carriers might work a hardship on such carriers. Therefore, we proposed that application of the price cap be voluntary during the four year period until completion of the first comprehensive performance review. This preserves the ability of small carriers, including those who do not participate in NECA pools, to continue under existing rate-of-return regulation. We also are seeking historical evidence of small company productivity experience as a possible basis for setting a separate productivity factor for small carriers.

Senator INOUYE. Our next panel consists of Ms. Sharon Nelson, Chairman of the Washington Utilities and Transportation Commission, and Ms. Gail Garfield Schwartz, Deputy Chairman, New York State Public Service Commission.

This panel is a very important one, and the presentation will have a very important impact upon the decision-making process.

May I now call upon Chairperson Nelson.

STATEMENT OF SHARON L. NELSON, CHAIRMAN, WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, ON BEHALF OF THE NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

Ms. NELSON. Thank you, Mr. Chairman. On behalf of the National Association of Regulatory Utility Commissioners, I wish to thank you for this invitation to testify today and for conducting this extremely important oversight hearing of the FCC's latest regulatory reform proposals.

I serve as Second Vice President of our national association and also as Chairman of the Communications Committee.

I had intended to append to my testimony the most recent resolution, adopted unanimously by the NARUC, and recommended unanimously by the Communications Committee. I had intended to append that to my testimony. It inadvertently was excluded, and I would like permission to file it in order to supplement the record, if that is all right with you.

Senator INOUYE. It will be included in the record by reference.

Ms. NELSON. Thank you very much.

I have heard a lot this morning that I would like to respond to, but I will attempt to keep my comments brief.

It seems that arcane language indeed does swirl around the telecommunications industry and regulation these days. But I think it is important to remember that regulatory commissions are uniquely American institutions. They were created first by the States and then the scheme was adopted by Congress for the creation, over a hundred years ago, of the Interstate Commerce Commission.

I think it is important to remember why this uniquely American institution was created, this unique private-public partnership. As Henry Adams, the Nineteenth Century historian stated, "It is important to remember that he who makes prices for necessaries controls the whole wealth of the nation, precisely as he who can tax."

To be sure, the telecommunications industry is going through changes. The monopoly characteristics that it used to be characterized by are being replaced by competition in many market segments.

At the same time, however, the essential nature of the service is becoming more pronounced. It was this combination of monopoly provider of essential service that caused the creation of the regulatory commissions in the first place.

As telecommunications technologies become ever more important to the rest of the economy, that perception of its essential nature requires that we proceed deliberately and cautiously with respect to reforming the mode of regulation for this industry.

This very paradox of the increasing essentiality of telecommunications services to our economy and lessening monopoly characteristics may account for the contentiousness of the debate you will hear today.

The State commissioners do wish to commend the FCC for advancing the debate and issuing the Further Notice of Proposed Rulemaking.

As this Committee well knows, the jurisdictions divide responsibility for the regulation of this industry. The FCC's actions inextricably and inexorably impact what the States do. When they shift costs from the inter- to the intrastate jurisdiction, we have to deal with it. When they establish access charges, many of us have mirrored interstate access charges in the intrastate arena.

When they establish new cost allocation schemes for separating regulated and unregulated services, our auditors attempt to deal with those new cost accounting systems.

This morning, listening to Chairman Patrick describe a rate-based rate of return regulation, often with a pejorative cost-plus contracting comparison, I was struck by the fact that it inevitably invites the comparison of the Catholic celibate priest conducting a sex education seminar. The FCC has candidly admitted in its notice of proposed rulemaking that it has not engaged in rate-based rate of return regulation much, if at all, in its history.

The States, Mr. Chairman, actually do engage in rate-based rate of return regulation. This is not to say that we have achieved regulatory nirvana. The States are well aware of the limitations of the current system and are actively moving in many jurisdictions to improve rate-based rate of return regulation to impose the correct incentives for this very dynamic industry.

I would like to leave you with four simple points this morning.

Chairman Patrick indicated that this is not profit deregulation. Well, that was the first time I had heard this proposal characterized as not being profit deregulation. Certainly, as many Members of the Committee noted, the financial analysts characterize it as profit deregulation, and have pointed out that the possibility of excessive earnings are very real.

Morgan Stanley, for instance, indicated that if the FCC proposed plan were adopted, it would expect to see firms earning upward of 15 percent. You have heard figures as high as 20 percent here this morning.

My testimony indicates that telecommunications firms are already outperforming other riskier sectors of the economy. They are, at present, earning higher returns than firms that are perceived as operating in more risky market segments.

So, apart from the hoped for productivity gains, I think it is important to ask if there is a viable public policy reason to accelerate the trend toward the possibility of excessive earnings.

The second point that I would like to emphasize is that the FCC's theoretical anchor is economic efficiency.

Now, we, in the States, have recognized that the Averch-Johnson effect has been described in the economic literature. To be sure, we attempt very diligently to discourage the gold-plating phenomenon that Chairman Patrick talked about.

But in this proposal, the economic efficiency goal is preeminent, and in our traditional mode of regulation, other valid public policy goals have also been included in traditional regulation. They include the quality of service points that have been discussed this morning, as well as redundancy and reliability concerns for the network and security for the network.

Certainly, the fire in the Hinsdale central office, which resulted in outage of service for many business and residences in the Chicago area, should give us some pause as we think about blithely dismissing those quality of service concerns.

The third point, which was also emphasized this morning by Members of the Committee, is the optional nature of this proposed plan.

The FCC did recognize that it had a political problem for small, rural companies who, at this point in their history, are probably unable to freeze their rates or even allow them to rise by an index pegged to the Consumer Price Index.

They will be faced with substantial cost increases coming again from the Federal jurisdiction, which will have to be dealt with at the State level. But the very notion of allowing companies the opportunity to elect which mode of regulation they will be regulated under is obviously, on its face, not an efficient or even-handed administrative scheme. It is obviously flawed in that respect.

Finally, there are numerous other detailed points in my written testimony which have been mentioned by others. But I think it is also important to emphasize what the NARUC resolution says. The FCC's proposal does not mesh well with the FCC's and with all regulator's stated goals of, where possible, letting competition protect consumers and removing regulation where competitive markets actually do exist.

The State commissions were very concerned about the incentives of this proposal to shift costs to the State jurisdictions. The resolution indicates that we might support, that this proposal could be recast in such a way, if it took into account the varying competitive characteristics of the varying markets which the FCC regulates. For example, in my State jurisdiction, Washington State, we have been able to differentiate the regulatory treatment that is accorded to carriers operating in markets that are effectively competitive, and by that I mean AT&T as well as the other inter-exchange carriers. We have differentiated their treatment from treatment of carriers which are operating still in heavily monopoly markets.

With that, I would like to conclude, Mr. Chairman, by saying that the State concerns do need to be addressed. We are more than willing to participate in this debate and think that this proposal perhaps could be refined. If it does have merit, it will survive Congressional scrutiny and further rounds of comments.

Thank you very much for your attention.

[The statement follows:]

STATEMENT OF SHARON L. NELSON, CHAIRMAN, WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION ON BEHALF OF THE NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

Mr. Chairman, members of the committee, thank you for your invitation to testify on S. 2044 and the Federal Communications Commission's (FCC) recent "price caps"

rulemaking proposal. My name is Sharon Nelson. I am Chairman of the Washington Utilities and Transportation Commission, a position I have held for three and one-half years. Before that, I was staff counsel to a state legislative committee investigating regulatory reform in the telecommunciations industry. I am Second Vice President of the National Association of Regulatory Utility Commissioners (NARUC). I also serve as Chairman of the NARUC Committee on Communications, and I was recently elected President of the Western Conference of Public Service Commissioners.

Today I am testifying on behalf of the NARUC. The NARUC is a quasi-governmental, non-profit organization founded in 1889. Within our membership are the governmental agencies of the 50 states, the District of Columbia, Puerto Rico and the Virgin Islands that regulate utilities and motor carriers. The mission of the NARUC is to serve the consumer interest by seeking to improve the quality and effectiveness of government regulation in America.

As you know, the FCC issued a Notice of Proposed Rulemaking (NPRM) a little less than a year ago seeking comments concerning the advisability of regulating dominant carriers by setting price ceilings on interstate services, and abandoning the traditional method of regulation that bases prices on telephone companies' *costs* and *profits*. The Commission tentatively concluded that rate of return regulation is no longer the optimal form of regulation. The Commission argued that price caps would encourage greater efficiency and innovation, reduce incentives to cross-subsidize, eliminate investment distortions, protect ratepayers against sudden steep rate increases, be simple to administer, and reduce the resources competitors need to devote to the regulatory process.

Although the NARUC submitted no comments on the FCC's initial price cap plan, the Association adopted a resolution pertaining to the plan at its 1987 Annual Meeting in New Orleans. The resolution urged the FCC to consider price caps for local exchange companies separately so that state commissioners, whose jurisdiction would be directly affected by the proposal, would have an opportunity to fully participate in the proceeding. NARUC also suggested that interstate price caps, if adopted by the FCC, be implemented on an experimental basis, with rigorous monitoring, and that they not affect current jurisdictional cost allocations or existing intrastate services and rates.

In response to overwhelming criticism that the Commission had provided only a "skeletal" plan—lacking hard data to show that ordinary telephone customers would be better off under a profit deregulation/price cap regime—on February 12, 1988, the FCC announced its intent to issue a Further NPRM containing the elements of a specific price cap proposal. At its March 1988 meeting in Washington, D.C., the NARUC passed a second resolution presenting the FCC with a number of exploratory questions to address in its Further Notice, and urging the Commission to provide adequate time to respond to the revised proposal.

On May 23, 1988, the Commission issued a 289 page Further Notice soliciting comments and questions on many previously undiscussed aspects of the plan. Under the amended plan:

AT&T and most local exchange carriers, including the Bell Operating Companies, would be eligible for price cap regulation. Use of price caps would be optional.

Prices to be regulated would be divided into two main groups or "baskets", one covering the switched public telephone network, and the other private lines which are typically leased to business and government customers.

There would be an annual increase in prices equal to the rate of inflation, but this figure would then be reduced by 3 percent to take account of productivity improvements. The 3 percent reduction was arrived at by taking the industry's historic rate of productivity improvements, estimated at about 2.5 per cent, and adding half a percentage point (a so-called "Consumer Productivity Dividend") as an incentive to additional productivity improvements.

Within the baskets, the carriers could charge for different services with a great deal of flexibility, although both individual increases and decreases would be subject to a maximum rate of 5 percent.

The Commission asked for comments by July 26 and replies by August 26, 1988. Due to the complexity of the issues, and to the fact that NARUC would be unable to discuss the new proposal prior to its summer meeting last week in San Diego, the NARUC requested a 30 day extension of time to file comments.

Unfortunately, the FCC has decided to put the Further Notice on a fast track inconsistent with the plan's significance and the magnitude of potential implementation difficulties. On July 14, 1988, the Commission denied NARUC's motion for a longer comment period. The day before, FCC Chairman Patrick, in a hearing before the House Subcommittee on Telecommunications and Finance, said he would not

rule out the possibility that a final order could be issued before the end of the year. NARUC has been foreclosed from filing initial comments, and reply comments are due roughly three weeks from today. I have attached the latest resolution endorsed by the NARUC executive committee.

The FCC's intention to press this process toward a year-end closure is cause for concern. Any attempt to forge a new regulatory structure that will accommodate the dynamic nature of the telecommunications industry into the twenty-first century while still guaranteeing protection for the consumer must receive careful consideration and will almost certainly require more than two iterations. There is simply no compelling need to conclude this proceeding in the time left for this Administration. As this committee knows, recent major policy initiatives such as passage of the transportation deregulation acts required more than one year to accomplish. If the Commission's plan has merit, it should stand up under Congressional scrutiny and the test of adequate time for review.

The Further Notice does respond to some of the concerns of state regulators. However, there are still a number of issues that need to be addressed.

1. A major concern is the optional nature of the plan. If a carrier determines it would be financially advantageous to remain under rate of return regulation, it has the option to do so. If carriers are free to pick the regulatory method which maximizes their profits, consumers could suffer. Because the carriers have access to substantially more financial and business planning information than they usually share with their regulators, the basis on which a carrier would make this choice may not be fully scrutinized. Assuming that some carriers opt for price cap regulation and others choose to stay under rate of return regulation, the FCC will be faced with administering two complex regulatory schemes simultaneously. Given limited agency resources, this dual regulation may not be administratively feasible, and would certainly not seem efficient.

2. The plan states that jurisdictional separations and cost allocations will not be affected by price caps. But under the proposal, carriers will have significant incentives to allocate more costs to the state jurisdiction where they are not under a price cap in order to earn higher profits in the interstate jurisdiction. To eliminate this negative incentive, my colleague, Chairman William Long of Michigan has suggested that the plan should be modified to require explicit, prior regulatory approval of any change in the relative allocation of costs between interstate and intrastate jurisdictions.

3. An approach that permits dominant carriers to transform all cost savings into profits may create a perverse incentive to cut corners at the expense of service quality. In an era when many retail companies are discovering that enhancing service quality is essential to survival, I find it ironic the FCC is pushing so hard for a system of regulation that provides incentives in the opposite direction. The Commission's amended plan discusses in just four short paragraphs how service quality will be maintained. The plan will continue with self-reporting by carriers—a requirement that amounts to self certification with no independent verification. The Commission's plan must strive to assure that diminution of service quality, such as that which occurred in the deregulated airline industry, is avoided.

4. The FCC's proposal would maintain rates in an assumed "zone of reasonableness" by imposing bands for different rate elements, limiting the maximum annual increase or decrease in rates for each service to 5 percent. First, a 5 percent band may be inappropriate since it appears that there have been no recent price increases of that magnitude. Second, it is not clear that it is appropriate or in the interest of consumers to have a floor on rate decreases.

The proposal includes a "y" and "z" adjustment mechanism to flow-through certain cost increases or reductions to consumers. These include such things as any change in access charges for the upcoming tariff year and any other exogenous cost changes such as tax law changes, separations changes and accounting changes. According to the FCC, these so-called "y" and "z" adjustments will guarantee that cost reductions will be passed through to consumers. Although all changes that will be treated as "exogenous" cannot reasonably be known at this time, it is important that the plan identify adjustments which can be known and quantify them in advance to ensure that these adjustments are properly made. The plan's lack of specificity in this regard raises the discomfort level of state commissioners.

5. The productivity factor also raises a number of questions. Cost reductions flowing from improvements in productivity may be much greater than the 3 percent assumes. In Great Britain, British Telecom has operated for 4 years under price caps limiting price increases to the rate of inflation minus 3 percent. In response to reports that the company is earning a 20.7 percent return on invested capital, British regulators recently increased the factor for productivity to 4.5 percent, effectively

limiting the average annual price rise for a number of the company's domestic services. Similarly, the investment firm of Morgan Stanley recently issued a letter opinion predicting "a sustainable return on equity of at least 15 percent" if the FCC plan is implemented.

In addition, it is not clear how the FCC determined the "Consumer Productivity Dividend" of .5 percent. Moreover, the productivity factor would apply to both AT&T and the local exchange companies, although, it was developed based on AT&T data only. Therefore, there is a serious question as to whether this historical factor is appropriated for the now divested local companies.

6. We need to determine if the "going-in" price of basket services are too high as a result of past "goldplating", excessive authorized return levels, or improper rate design. It would be circular in any system designed to replace rate of return regulation to use baseline rates established under the rate of return method. If current rates are assumed to be proper for initiating price caps, then the basis for replacing rate of return regulation collapses.

7. The FCC states that the current policy favoring geographic toll rate averaging would remain intact. The Commission notes that any pressures for geographic rate deaveraging likely to emerge under the plan might also arise under existing cost of service regulation. Our concern here is that the FCC's Further Notice discusses primarily the extreme form of route-specific deaveraging. Rate deaveraging also can occur in forms other than route-by-route deaveraging. For example, the development of high, medium and low cost national rate schedules could seriously disadvantage consumers in rural or high-cost areas. Such strategic rate restructuring is quite possible under the price cap scheme given the level of flexibility within each service band, and the ability to institute conterbalancing increases and decreases within each "basket."

8. Under the proposal, new services would initially be offered outside the price cap structure where they would be subject to the FCC's tariff process. During an interim period, a "net revenue test" would be applied to these new services. The FCC states that, in addition, these tariff filings would be fully subject to challenge in the complaint process. However, the FCC's current complaint process is not administratively simple and is not perceived as fair as complaining parties. The FCC has rejected tariff challenges on grounds that "no compelling arguments have been presented that the tariff proposal is patently unlawful." Thus, the burden on the opponents of tariffs may be unreasonably high.

9. The plan does not mesh well with other FCC policies dealing with competitive issues in this industry. This proposal does not distinguish the markets in which these carriers operate with respect to competitive characteristics. It is generally conceded that access services are monopoly services, whereas AT&T's services face greater competition. Peter Huber, the Justice Department's consultant in the triennial review of the AT&T consent decree's line of business restrictions, explained to a George Washington University telecommunications policy symposium last December, "If delivered in half measure and without support from a surrounding—a very strong pro-competitive regulatory policy all around, the price cap or price minus plans that have been put forward can surely make things worse, rather than better." The proposed rate element band of plus or minus 5 percent under the plan is not adequate to preclude cross subsidization of competitive services through monopoly rates, or to protect competitors from predatory pricing.

10. The FCC states that it would engage in ongoing monitoring of the plan, and at the end of the third year, it would conduct a comprehensive performance review of the plan to determine whether it needs to be modified. The specifics of the FCC's monitoring must be developed and reviewed *prior to* to implementation. An evaluation of the plan's viability and equity to both companies and without advance consideration of the specific criteria that will be used in the comprehensive review. The scope of data to be collected throughout the plan's operation must be known in advance.

In deliberating the reform or replacement of rate of return regulation, it is incumbent upon us to take great care. In my view, people who talk of a complete, absolute end to rate of return regulation are naive. Rate of return will always remain the touchstone by which we and, significantly, the courts, judge regulatory effectiveness. The judgment of the reasonableness of a regulated firm's overall operation and level of rates will always come back to an assessment of profit—measured by the firm's rate of return on investment.

Critics forget that the foundations of rate of return regulation are based on the United States Constitution. If a telecommunications company enters into a new "social contract" and end up earning no profit, it will surely seek a way out of that contract by arguing to the courts that its rate of return amounts to confiscation

under the Fifth Amendment. Rate of return is the accepted legal test for the determination of confiscation. Rate of return also provides investors signals about the riskiness of the utility compared to other enterprises. On the other hand, if we adopt alternative regulatory mechanisms which allow rates of return to climb to excessive levels, the Commission would be vulnerable to lawsuits for not setting fair, just and reasonable rates.

It is important to acknowledge that the United States has the best telephone system in the world and that rate of return regulation has accompanied that development. With rate of return regulation, rate increases for telephone services have been about one-half of the rate increases for all other prices for goods and services as reflected in the Consumer Price Index (CPI). The "real cost" of telephone service has declined by 60 percent over the past 25 years. [*Primer and Sourcebook on Telephone Indexes and Rate Levels*, Industry Analysis Division—Common Carrier Bureau, Federal Communications Commission, p. 10 (April 10, 1987)].

Returns to telephone company shareholders under rate of return regulation have also been impressive. According to a study released by the NARUC in May of this year, the common stockholders of almost all major electric and telephone utility companies earned a higher return on investment than did the average stockholder of the major U.S. industrial corporations over the 16 year period 1972–1987. The study found that electric and telephone utility stockholders earned an average internal rate of return of 13.13 percent, while the Standard and Poor's Index of 400 Industrials earned 11.46 percent and the Value Line Industrial Composite returned 11.78 percent during the same 16 year period. Now, I don't believe that this record is particularly complimentary for traditional regulation, since generally the objective of regulators is to establish returns commensurate with risk. Therefore, in my view, much less risky utilities should not be outperforming companies operating in riskier markets. Nevertheless, I cite the NARUC study because it presents rather forthrightly the chief public policy question facing Congress and the nation: Do we want companies which still retain substantial monopoly characteristics earning returns above 15 percent as suggested by Morgan Stanley, or on a par with the spectacular 20 percent plan earnings of British Telecom? Do we want to actively, explicitly encourage diversion of wealth from captive customers to monopoly companies' shareholders? What public policy rationale supports allowing these companies reap such rewards?

There may be modifications of rate of return regulation that are superior to both the traditional system and to this price cap plan. Since divestiture, the states have been functioning as policy laboratories in the development of promising new improvements on rate of return regulation. State regulators are closely tracking the progress of New York's incentive regulation plan, New Jersey's rate stability plan, deregulation in Nebraska, Vermont's attempts to draft a social contract and a host of other state experiments. The Washington Utilities and Transportation Commission is currently involved in a Notice of Inquiry on incentive regulation for the local exchange companies. We have initiated a rulemaking to establish guidelines for generic range rates of return on equity, and we are examining the use of "bonus" returns as are currently used in New York to promote innovation and productivity. We also are proposing to streamline the procedure for rate cases involving cost shifts coming from the federal jurisdiction.

It may well be true that rate of return regulation is simply no longer suitable for AT&T. When the Washington Commission reached a similar conclusion regarding AT&T's intrastate operations, we did more than modify rate regulation, we essentially *eliminated* rate regulation. The company is allowed freedom to set prices almost any way it likes because we found that those prices generally are subject to the bracing discipline of effective competition. It is our policy in Washington State (as required by the state's Regulatory Flexibility Act) that the removal of regulatory constraints *follows* rather than precedes the appearance of effective competition. Our focus is on the captive customer. Until effective competition presents that customer true market options, our current state law requires the Commission to afford that customer protection from monopoly pricing. We also are empowered to detariff competitive services offered by companies which retain monopoly characteristics on a service-by-service basis.

We at the state level strongly advocate a close examination of the purpose of regulation. One major goal of the FCC's price cap system is to encourage "least cost" investment strategies on the part of telecommunications firms. However, some policy makers are beginning to inquie if our public policy goals should be devoted entirely to economic efficiency and "least cost" networks. For example, members of the House of Representatives are actively seeking to promote "information age"

services. It may turn out that *more* investment is called for to "prime the pump" for the information age infrastructure.

The Mothers Day fire in Chicago, which knocked out a major telephone switching center, also points out that more capital or additional labor expense may be required to provide a higher level of redundancy and reliability in the public network. Other traditional public policy goals of adequate quality, international competitiveness, system reliability and redundancy also need to be considered as we refine and improve regulatory institutions and proceedings. The businesses which lost thousands of dollars and the residential customers who endured prolonged inconvenience as a result of the failure of that Chicago switching office would probably agree.

The states are open to and, in fact, have taken the lead in developing new regulatory approaches while continuing to protect monopoly ratepayers. Our commitment to improve is sincere. If the price cap model is to be implemented successfully, substantive and procedural concerns of the states most be addressed and resolved. The FCC may choose to ignore these concerns, but that will only increase the confusion and uncertainty that now surrounds this price cap proposal.

Thank you for your attention. I would be pleased to answer any questions.

Senator INOUYE. Thank you very much.

I note in your prepared remarks that your organization has recommended to the FCC that they consider the price cap separately for local exchange companies.

Have you had any response to your recommendation?

Ms. NELSON. No, Mr. Chairman.

We just met last week in San Diego and adopted this resolution. We will now be filing comments in the reply phase. The comments will be essentially initial comments. But now that we have taken a policy direction, we will be filing comments in the reply phase. We have had no informal or formal response to that recommendation.

Senator INOUYE. Why do you think it is important that this comment period be extended and the proceeding be slowed down a little?

Ms. NELSON. Mr. Chairman—and I certainly want Gail Schwartz, who is the Task Force Director of our Communications Committee to chime in any time here, because she has studied these issues in great detail.

Chairman Patrick characterized this not as a vast change, not as a radical change from regulation, as we have known it. However, it appears to us in the States that it is a rather radical change. It seems to me, we had notice—well, it's been a year since we have had notice that the FCC proposed to adopt such a theoretical proposal.

As you well know, as this Committee well knows, the transportation deregulatory acts were adopted after the compilation of voluminous hearing records with great empirical evidence, as well as theory being presented to you. It seems to me that this kind of far-reaching change in approach will have substantial impacts on our State jurisdictions and needs to be taken with a great degree of certainty. Any decision to make such a change needs to have a great degree of certainty and consensus around it, so that we all know what to expect and how to explain the resulting impacts to consumers in our respective jurisdictions.

Senator INOUYE. Ms. Schwartz, do you have anything to add?

Ms. SCHWARTZ. No, Senator Inouye. I would endorse that completely. When I extend my remarks to you, shortly, I will elaborate. Primarily, there is no empirical evidence as to the assertions that are made for the basis of making the productivity factor adjustment, which is claimed by the FCC to be the consumer benefit.

There is very little demonstrable competition. And, contrary to what Chairman Patrick has said, and in spite of my great respect for the FCC's efforts to respond to earlier comments to its initial Notice of Proposed Rulemaking, it is my belief, as an economist, that the presence of competition is the key to the success of a price cap regulatory scheme, and that you must adjust an incentive scheme to the degree of competition.

I think that this price cap proposal, as distinguished from "a theoretical price cap proposal" fails in that regard.

Senator INOUYE. Senator Breaux, do you have any questions before I call upon Ms. Schwartz?

Senator BREAUX. No, thank you. I will just wait.

Senator INOUYE. Ms. Schwartz.

STATEMENT OF GAIL GARFIELD SCHWARTZ, DEPUTY CHAIRMAN, NEW YORK STATE PUBLIC SERVICE COMMISSION, ON BEHALF OF THE NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

Ms. SCHWARTZ. Thank you, Senator.

Mr. Chairman, I really am delighted to represent the New York State Public Service Commission, as well as the NARUC, in offering these views on S. 2044, which, I guess you have guessed by now, will be basically in support.

As Sharon Nelson mentioned, I did serve as the Task Force Leader for the NARUC in developing our comments, and I have had somewhat of a hand in furthering incentive regulation in New York.

I have submitted about 13 or 14 pages of written testimony, which I request be made part of the record, and in my oral remarks, I am going to concentrate on the first four and the last three of these pages.

I certainly support fully, as I am sure we all do, the goals that the FCC is pursuing: to increase incentives for productivity and innovation; to nurture emerging competition; and to decrease carriers' incentives to cross-subsidize.

Unfortunately, I do not believe that the price cap plan, as presently constituted, will achieve these goals. It is the wrong way to get to the right end.

As summed up in the NARUC resolution, adopted July 27, the price cap proposal is deficient in the following main ways. It fails to insure consumers receive an equitable share of any benefits that may flow from this form of regulation. It fails to effectively cap the prices of dominant telecommunications carriers and, by its grant of excessive pricing flexibility, it undermines the efficiency incentives that it seeks to promote.

It contains insufficient protections against the potential for anticompetitive pricing by dominant carriers, as well as the potential for cross-subsidization of more competitive services by those subject to less competition.

And, it fails to adequately establish the nature and specific provisions of the review of price cap regulation, thus allowing for the possibility of excessive earnings levels by dominant carriers.

90-108 O - 89 -- 3

As a result, the plan actually insulates carriers from inflation, putting them in a position that no rate payer and no unregulated business enjoys.

The FCC's reliance on an indexed price cap, incorporating a productivity adjustment based on historical performance, is the primary cause of the plan's failure in this regard.

Any factor based on historic performance alone is likely to diverge from actual future performance.

It is especially ironic that the FCC defends so strongly, as a consumer benefit, a factor that reflects historical experience under rate of return regulation, which, admittedly, discourages efficiency. If the inefficiencies of the former regime were as great as is claimed, then surely the theoretically more efficient regime of price caps should result in a higher than historic productivity increase.

A second major flaw is found in the banding scheme, which creates a total potential increase of 20 percent over the four year experimental period. The degree of discretion to increase price for some services is excessively high for the less elastic and less competitive services because it is unrealistic to expect that the customers of such service will be protected from prices far above cost by the constraints of the competitive market. Those constraints simply have not proven to exist.

The carriers would have the ability and the incentive to decrease prices of their more elastic and competitive services and to offset those decreases with higher prices for the less elastic services.

Finally, a major deficiency of the proposed plan is that it would use existing rates as a starting point, with no demonstration that those rates are just and reasonable.

Now, Senator, there has been some discussion in the previous panel of the New York proposal, and I would like now to turn to that, with your permission, which is discussed on page 10, and compare what we have done in New York with what the FCC proposes to do, and I hope show you the superiority of our approach.

The FCC discussed in its own further notice our plan. Unfortunately, although I do greatly appreciate Chairman Patrick's bow to our plan, I am sorry to say that I think the FCC has failed to fully comprehend what it consists of.

It applies to New York Telephone Company, the other local exchange carriers, that is, the large ones, and a couple of the small ones, and AT&T Communications, that provides intrastate toll service.

It refers to a moratorium on general rate case filings, which was agreed to by the company for a set period of years, in exchange for the opportunity to earn more than it would be able to earn under traditional rate of return regulation.

Therefore, although it is referred to throughout the notice of proposed rulemaking as the "moratorium plan," I think it is better to call it an "incentive plan," for that, indeed, captures its essence and its intent.

Our approach was to freeze existing rates in some instances, after having reduced them first, and if those rates lead to earnings in excess of a target rate of return, to require, or, if you like, to

permit a 50/50 sharing between rate payers and the company of the excess.

Revenue neutral rate design changes, supported by cost of service studies, are permitted by Commission action.

The FCC compares this to the British price cap approach and impliedly, in its latest proposal, finds it inferior. However, I think that it is far superior and that reliance on the British experience is misplaced, chiefly because, prior to its privatization, British Telecom was a state monopoly and the price cap regime instituted in Britain was chosen to contribute to the success of what was then the largest stock offering in history.

Under the New York moratorium, the incentives for efficiency, which is what we are after, are not limited to the 50 percent sharing of earnings over 14 percent, because any gap between the target rate of return and the earned rate of return below 14 percent may be retained entirely by the company.

The FCC also designated the rate moratorium as a temporary expedient and found it wanting in that regard, indicating that a full-scale cost of service rate of return review would still be required and implying that that was an inefficient way of regulating. But we submit that under price caps, the FCC would have to do similar, periodic reviews. I think I heard Chairman Patrick today say that the FCC, although it did not say so in its further notice, does intend to adjust either the caps or the bands or both, should its periodic review find that earnings are excessive.

I do not think there is any choice in that, Mr. Chairman, because if the FCC does not conduct such a review, it would simply have abdicated its responsibility to protect customers of monopoly services from being gouged by the provider of those services. Those customers, as you well know, may be in different places of the country, not necessarily all customers of any one service.

Finally, so as not to take up too much time, I want to emphasize that we in New York have permitted rates for competitive services to be changed within a present range without prior approval of the Commission. So we have granted the companies the flexibility, which we agree is valuable to encourage efficiencies.

But the FCC's proposal would not do that because it offers only two baskets and a banding scheme, and, therefore, does not distinguish between the more or less competitive services.

So, in support of this proposed legislation, I would suggest that, during the further consideration period, a more careful comparison of the approach that we have adopted and had in place now for almost three years be made and that a modified plan for AT&T and the local exchange carriers, which is a price cap approach, but which does not have the faults that the present price cap proposal has, be considered in terms of its costs and its benefits for all consumers, and not just the major business consumers who would be entitled to many benefits under the present proposal of the FCC.

Thank you, Mr. Chairman.

[The statement follows:]

STATEMENT OF GAIL GARFIELD SCHWARTZ DEPUTY CHAIRMAN, NEW YORK STATE PUBLIC SERVICE COMMISSION ON BEHALF OF THE NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

I am pleased to represent the New York Public Service Commission as well as the NARUC in offering these views to this distinguished committee.

In its Further Notice of Proposed Rulemaking (FNPR) in CC Docket No. 87-313 (released May 23, 1988), the FCC has addressed many of the criticisms leveled at its original price cap plan and has proposed a more specific plan that attempts to correct the deficiencies of the earlier proposal. Its goals—to increase incentive for productivity and innovation, to nurture emerging competition and to decrease carriers' incentives to cross-subsidize—are laudable. Unfortunately, the price cap plan, as presently constituted, will not achieve these goals.

As summed up in the NARUC resolution adopted July 27, 1988:

The price cap proposal is deficient in that it fails to ensure consumers receive an equitable share of any benefits that may flow from this form of regulation;

The current proposal fails to effectively cap the prices of dominant telecommunications carriers, and by its grant of excessive pricing flexibility, undermines the efficiency incentives it seeks to promote;

The current FCC price cap proposal contains insufficient protections against the potential for anti-competitive pricing behavior by dominant carriers, as well as the cross-subsidization of more competitive services by those subject to less competition;

The current proposal fails to adequately establish the nature and specific provisions of the review of price cap regulation, thus allowing for the possibility of excessive earnings levels by dominant carriers.

The major flaw in the Commission's plan is that, contrary to the promise of its title, this regulatory scheme does not place an upper limit on, or actualy "cap", rates. Rather, it limits the total benefits consumers will receive, by relieving carriers of the obligation to reflect all cost savings in rates, without imposing a commensurate risk of underearnings upon those carriers. Indeed, the plan actually insulates carriers from inflation, putting the carriers in a position no ratepayer or unregulated business enjoys.

The FCC's reliance on an indexed cap incorporating a productivity adjustment based on historical performance (2.5 percent) is the primary cause of the plan's failure in this regard. No historical productivity factor can guarantee fair treatment for ratepayers, because any factor based on historic performance is likely to diverge from actual future performance. Thus, it is especialy ironic that the FCC defends so strongly as a consumer benefit a factor reflecting historical experience under rate-of-return regulation, which admittedly discourages efficiency. If the inefficiencies of the former regime were as great as claimed, surely the theoretically more efficient regime of price caps should result in a higher-than-historic productivity increase.

A second major flaw is found in the banding scheme, which permits carriers to modify the individual service rates within a range of ± 5% annually, creating a total potential of 20% over the four-year experimental period. This degree of discretion to increase price is excessively high for the less elastic and less competitive services because it is unrealistic to expect that the customers of such services will be protected from prices far above cost by the constraints of the competitive market. The carriers would have the ability and incentive to decrease prices of their more elastic and competitive services, and to offset these decreases with higher prices for the less elastic services.

Another shortcoming of the proposed plan is that it would use existing rates as a starting point, with no demonstration that those rates are just and reasonable, and without consideration of the earnings levels those rates will produce, and without provision for preventing an unwarranted windfall for the carriers and an unnecessary penalty for ratepayers.

We are also concerned that the Commission has not provided adequate safeguards against deteriorating service. It must be anticipated that the carriers will be tempted to improve earnings in art through shortchanging the quality of service they provide. It is therefore incumbent upon the Commission, in conjunction with the implementation of price cap regulation, to promulgate strict quality of service standards and the procedures necessary for enforcing those standards. We see little evidence that the Commission has replied to earlier expressed concerns of the states on these points. Should that happen many large and small consumers would be harmed, and they would likely lodge complaints with state regulators, who would be powerless to solve the problem.

A simpler and fairer system would not to index at all. After review and possible adjustment, rates could be capped at on initial level with no opportunity for auto-

matic annual increases. This would give carriers strong incentives for increased efficiency to offset inflationary cost increases. Ratepayers would benefit to the extent that competition forces some prices down.

It would also eliminate the imbalance in the present plan, which allows not only inflationary price increases, (to the extent not offset by the productivity adjustment), but also would allow additional 5% annual increases regardless of the companies' earnings. We see no justification, absent the checks on price increases that would be provided by full competition, for granting companies such wide latitude to restructure their rates—unilaterally and dramatically—under the guise of enhancing their efficiency. Optionality would on the contrary constitute a perverse incentive for those carriers that are most in need of efficiency incentives to elect rate of return regulation. Carriers predicing that shareholders will benefit from price caps will elect caps, and carriers predicting ratepayers will benefit will elect rate of return. If the price cap plan is determined to be in the public interest, it should be mandatory.

PRICE CAP INDEX [PCI]

The central feature of the price cap plan is the Price Cap Index, according to which rates may be automatically escalated each year. This index is comprised of three elements: a general inflation factor, a productivity offset and the Consumer Productivity Dividend. The FCC's estimation of these factors has resulted in a PCI which can only operate to the disadvantage of the ratepayers. While this index appears in general to be sound, its use is unsupported for the specific task for which it would be used by the FCC. In particular, the FCC has failed to provide any analysis that shows how the GNP-PI would track historic telecommunications costs and prices. It has also failed to demonstrate that the productivity measures that were independently derived are at all similar to the productivity embodied in the GNP-PI. Finally, the specific analysis of AT&T's prices since 1984 is so seriously flawed as to be unusable. Hence, no price cap mechanism based on the GNP-PI is currently justifiable.

The productivity offset that purports to pass benefits to ratepayers has not been shown to be adequate. In particular, the FCC has not demonstrated whether it is adequate either for AT&T or for any carrier other than AT&T. All reliable studies indicate both a higher historical level of productivity and a rising tend in productivity, which have not been accounted for in the FCC's productivity adjustment factor.

It is the FCC's intention, of course, to impute an additional productivity factor—the so-called consumer productivity dividend (CPD)—to reflect at least a portion of the additional productivity it assumes price cap regulation will induce. Under the FCC's scheme, such a CPD is absolutely necessary to ensure that consumers get an appropriate share of any benefits that may flow from this regulation. But .5% is not based on projections and is dwarfed by errors in the CPI.

The FCC has chosen to lump the thousands of interstate rate elements into two "baskets" for AT&T and two "baskets" for the LECs (although it is considering a further breakdown of the LECs special access services basket). The caps would apply only to the baskets, not to rate elements for services within them. The FCC itself recognizes that this degreee of disaggregation is inadequate to provide adequate safeguards against pricing abuses and has chosen to supplement the baskets with a system of banded prices. As proposed, however, the bands will not provide consumers with adequate protection. Prices for inelastic services could rise above the upper limit of the band. There could be an incentive to use revenues from these services to subsidize services priced below cost, thus keeping competition from lowering prices permanently. The assessment of justifiable cause for raising prices above bands would be very costly in administrative time.

Price reductions below the band would not under the FCC proposal, require cost support which means strategic pricing might not be prevented. At the very least, pricing reduction below the band, if allowed, should be subject to a minimum duration.

There is yet another way that the price cap plan could fail to deliver the promised benefits for certain classes of customers, and that is the possibility that current rates for certain classes aer excessive. Since these rates serve as the starting point, it would be valuable for the FCC to undertake a review of the starting point, at least for critical, least competitive services.

RISK SHIFTING

On balance, it seems clear, the CC's proposed price cap plan does not succeed in shifting risk to the regulated firms, as it was the FCC's intent to do. The inflation

rate adjusted for productivity is too high, and the consumer "dividend" is too low. Even if the PCI were set at a point which perfectly identified both the inflationary pressures to be experienced by the carrier and the productivity which the carrier could be expected to achieve under the current regulatory scheme; and if the FCC also identified the consumer dividend to represent, say, 50% of the additional productivity the carriers could be expected to achieve—no significant risk will have been shifted to the carriers.

Moreover, even if the productivity offset were to present the carriers with some risk, the carriers still would not face a true "cap". The carriers can "pierce the cap" by implementing above cap rates if warranted by the carriers' costs, basically reverting briefly to rate-of-return regulation if earnings fall below expectations. This sounds like a very familiar remedy. By the very definition of the PCI to impute a repetition of past experience and merely share a modest degree of additional productivity—the downside risk is increased minimally if at all. Despite the minimal risk associated with such program, the FCC adds an overlay of traditional rate-of-return remedy if the PCI nevertheless still proves to provide an inadequate return. In short, the carriers are as fully protected on the downside as ever.

In contrast, the upside opportunities will be greatly increased by the price cap regulation. The carriers may earn with impunity (with no obligation to reduce rates or to share the bounty with ratepayers) at rates will in excess of a resonable return. Under the FCC's plan, only unconscionably high earnings ("statutorily-precluded exorbitant rates") would trigger corrective action.

This is unacceptable and totally incommensurate with the level of risk the carriers are presented with. The assymmetry of the FCC's proposal arrangement constitutes an unacceptable reassignment of risk.

PERIODIC REVIEW

Price caps cannot function properly over an extended time without periodic review of earnings performance. The FCC has recognized the necessity for this review at the end of the first experimental time period. However, if price caps are continued beyond the first review period, it will be equally as important to conduct rate-of-return reviews on a continuing periodic basis.

We agree with the FCC that retroactive refunds are inappropriate (unless as part of a sharing mechanism) and, further, that stating the precise level of carrier earnings that would result in corrective action might be counter-productive. (This is particularly true since what earnings are excessive and what threatens financial collapse will be a function of the fluctuations of the financial markets). However, it is equally important to state that if clearly excessive returns are earned, adjustment and recalibration will occur.

Service quality should not and need not be shortchanged by price cap regulation. Competition alone can not yet be relied upon to assure that minimally acceptable levels of service are universally available. And, even when service measurements are not necessary as a guarantor of service quality, such measurements are needed to keep the consumer informed about all of the telecommunications options available.

The FCC tentatively concludes that price cap regulation should initially be elective, because such optionality will "provide a means of avoiding any unforeseen difficulties relating to carrier diversity without running a risk of harming the public interest." This is clearly wrong. Regulators have the obligation to design a regulatory method that is in the public interest.

NEW YORK "RATE MORATORIUM" COMPARED

In this Docket there has been a great deal of discussion about the "rate moratorium" form of regulation the NYPSC currently applies to New York Telephone (NYT) and other carriers including AT&T Communications (intrastate service).

This refers to a moratorium on general rate case filings, agreed to by the company for a set period of years in exchange for the opportunity to earn more than it would be able to earn under traditional regulation. I prefer to call it "incentive" regulation, for that indeed captures its essence and intent.

Briefly, our approach has been to freeze existing rates—in some instances, after having reduced them first—and, if these rates lead to earnings in excess of a certain rate of return, to require a 50/50 sharing between ratepayers and the company of the excess. Revenue neutral rate design changes, supported by cost of service studies, are permitted by Commission action.

The FCC compares this to the British price cap approach, and impliedly the FCC's latest proposal, and finds it inferior. However, the FCC's assessment of the

strengths and weaknesses of the moratorium approach is flawed, and the basis of comparison is lacking. Our discussion of this matter is contained in comments filed with the FCC by the NYDPS in this docket and the Committee may at its discretion incorporate them by reference into this testimony. But it is worth saying here that reliance on the British experience is misplaced, chiefly because prior to its privatization, British Telecom was a state monopoly, not subject to the regulatory controls that telecommunications firms in the United States operate under. Price caps were chosen to contribute to the success of the privatization of the industry. The regulatory regime had to facilitate what was then the world's largest initial stock offering by making the offering sufficiently attractive to large numbers of investors. A price cap plan, once modified to rectify the noted deficiencies, would constitute an acceptable form of innovative regulation. In the alternative, the NYPSC approach to regulation would be a workable partially tested, alternative. I will summarize the features of that plan. Elaborated deficiencies of the so-called price cap proposal are in pp. 5–38 in the NYDPS comments in this docket, filed with the FCC July 26, 1988, and incorporated into this testimony by reference.

Two features of the NYT moratorium plan not mentioned in the FNPR, the omission of which tainted the conclusion reached by the FCC, are: First, the NYT plan required a $100 million (2%) rate decrease in September 1987 and a $400 million (8%) reduction in wire rates in December 1989. These net rate reductions did and will occur despite the need for increased revenues to complete the amortization of inside wire costs; these benefits to consumers are in addition to the decline in real prices, averaging 2½% over four years (1986–89).

Under the moratorium, moreover, the incentives for efficiency are not limited to the 50% retention of earnings over 14%. In fact, the "target" equity return allowance implicit in the revenue allowance was 13.25% in August 1987, and will be about 12% in August 1988. New York Tel will be permitted to retain all earnings up to 14% and 50% thereafter.

The FCC also designates the rate moratorium as a "temporary expedient" which merely "postpones the day of reckoning"—a full scale of cost-of-service and rate-of-return review. This view understates considerably the administrative savings of the postponement. A cost-of-service review every fifth year, for example, represents a considerable efficiency improvement over an annual cost-of-service review. Moreover, we submit, under price caps the FCC should do similar periodic reviews. Otherwise, as discussed further above, the FCC will have simply abdicated its responsibility to protect customers of monopoly services from being gouged by the provider of those services. And NYPSC can at our option extend the moratorium, without such full-scale review.

The New York approach has another feature which, contrary to the FCC's assessment, renders it superior to price cap regulation: under the moratorium we have continued our policy of treating non-competitive and competitive services differently. Our approach is more targeted to meet the needs of the particular markets in question. For many years, the NYPSC has permitted rates for competitive services to be changed within a preset range without further prior approval of the Commission. Rates for monopoly services, on the other hand, are monitored more closely. Services in emerging competitive markets are treated in yet other ways. Touchtone and Custom Calling, while technically monopoly services, are treated as competitive services due to the existence of a thriving market of alternatives such as touch-tone pads, answering services and answering machines.

The price cap scheme tentatively adopted by the FCC fails to tailor the regulatory response to the different markets being regulated. The price cap plan could be modified to be more differentiated in its treatment of less and more competitive services.

Pending the development of a more acceptable price cap plan, including a much more satisfactory identification of the various components of the PCI—and the closing of what promises to be an enormous gap between the FCC's modest estimate of historically achieved productivity (plus .5%) as reflected in the PCI and the actual productivity we expect will occur in response to price cap regulation—I offer a modified plan for AT&T and LECs. Current rates should be tested and adjusted as necessary to ensure that they produce a reasonable rate of return. Rates should then be capped at those levels, and only cost-justified, revenue neutral price changes should be allowed thereafter. The effects of exogenous cost changes, such as separations and tax changes, should be flowed directly through to rates. The carriers' earnings should be reviewed periodically and rates adjusted as necessary. The benefits resulting from efficiency and productivity gains should be shared with ratepayers through a provision for refunding 50% of any excess earnings.

ADDITIONAL STATEMENT BY DEPUTY CHAIRMAN GARFIELD SCHWARTZ

Attorneys for British Telecom have implied that my replies to Chairman Innoyes' questions regarding quality of service in Great Britain under a price cap regime obfuscated the facts. On the contrary, my answer spoke to the fact that British Telecom does not apply the same standards of service quality as we in New York do; and I would add to that statement, explicitly, that our standards are superior and should be the model for the FCC.

Attached is a summary of the major technical and consumer standards used in New York.

Procedures followed by the New York State Public Service Commission include notices for comment and public hearings if necessary. The FCC, as the Committee knows, does not follow such procedures which is another reason why states are skeptical of its ability to monitor service under a price cap regime.

In addition to the 20 persons in the Communications Division of the New York State Department of Public Service who monitor service quality, 10 persons in the New York Department of Public Service Consumer Services Division are assigned and spend significant amounts of time on service matters. Periodic management and operating audits required under New York State law also address the sufficiency of company service monitoring, repair and maintenance operations.

In New York State, we have three existing payment programs regarding service quality in repair and installation. In addition, two other programs, which are similar in concept if not in payment amount to the BT plan, have been offered by the staff in its proposed revisions to the Commission's Telephone Service Standards. Regarding our existing programs, one in special services permits customers to receive early installation in return for a premium payment. The other two existing programs involve refunds to customers when repair or network service is sub-standard: a refund of 1/30 of the monthly local access charge when a customer is out-of-service for one full day and 2/30 for every full day thereafter; and a refund of $1.50 per month under the Commission's Basic Service Index plan when a combination of repair and network performance is sub-standard during two of any three consecutive months. The out-of-service credits are received routinely by customers, but no customer has received a BSI refund since 1973.

The staff has offered two additional refund plans in its proposed revision to the Commission's Telephone Service Standards. One provides for refunds of a portion of, and up to all installation charges, when telephone companies miss an installation appointment with customers. The other provides a $2.00 per month refund to customers whose local exchange exhibits high trouble report rates for three out of six consecutive months.

Senator INOUYE. Thank you very much.

There is a vote pending in the Senate at this moment, so we will stand in recess for ten minutes.

[Brief recess.]

Senator INOUYE. The hearing will please come to order.

In response to my final questions to Chairman Patrick, the Chairman suggested that any delay in the proceedings would mean a denial to consumers of about $1.6 billion. Do you have any comments to make?

Ms. SCHWARTZ. First of all, I don't see how he can know what the denial of price reductions would be. I see no evidence anywhere that we can possibly predict that that would occur. But I think that the risks to the consumers of future disbenefits from a hastily developed and unsupported regulatory regime must be far in excess of any short-term benefits that might accrue to them. I think that the delay might deprive shareholders of incremental earnings in the short run. But I don't think that that is the mission of the regulatory body, to enhance the earnings of shareholders.

Senator INOUYE. What would you consider to be a reasonable level of return?

Ms. SCHWARTZ. A reasonable level of return would vary, of course, with the financial markets, and it is calculated on the basis

of the cost of capital, and on the basis of the capital structure for each individual firm, which is one of the reasons why a productivity adjustment, which would be the same for all firms, is such a difficult notion to accept. Since each firm has a different cost of capital, it is sort of hard to imagine an across-the-board factor that would be good for all of them.

In the present environment, something around 12 percent or 12.5 percent is certainly adequate. But that could change very soon, and it would be very hard to predict.

What I have suggested in other forums, and what strikes me as reasonable is that the price cap regime be implemented without an index for inflation, and with a periodic earnings review, and at the time of the earnings review, the real earnings would be compared to the earnings of comparable firms in the economy at large, and that would be your norm, rather than a target rate of return. So, it would vary with economic conditions.

The other alternative is the one I explained earlier, where we set a target which we revise periodically and then allow the company to keep the excess over that target.

Ms. NELSON. May I add to that briefly? In our jurisdiction we keep track on a monthly basis of earned returns for all of the companies which we regulate. In telecommunications right now, we see actual earned returns in the 12 to up to 15 percent area for the 25 companies that we regulate.

As Commissioner Schwartz indicated, we have authorized differing overall returns, depending on the specific factual circumstances for each company.

In the energy area, we see much lower returns than that, I think also indicating another problem with the proposal. At this point, we are at a unique time in history, where we have a declining cost industry. That may also account for the handsome returns that we see on the telecommunication side and the less than 12 percent returns that we see on the energy side.

Senator INOUYE. Do you believe that the price cap approach would provide incentives to reduce quality of service?

Ms. NELSON. There certainly is that possibility, and it has been emphasized in the House hearings by our colleagues from Michigan and from the District of Columbia Commissions. Insofar as the incentive, explicitly it is to ask carriers to cut their costs and to then reap the profits that will follow. It is of concern to us that the quality could suffer if costs of maintenance are delayed or new investment is inadvertently or explicitly delayed as well.

Gail might wish to add to that.

Ms. SCHWARTZ. Our experience in New York has been that monitoring quality of service under a price cap regime or an incentive regime is as difficult as it is under regular, old-fashioned regulation. We have always done it intensely in New York.

If there is one thing that possibly we might have done better in the first instance in our incentive plan, it would have been somehow to attach the value of the sharing of the excess earnings in some more explicit way to the quality of service achieved, rather than having to go back on a case-by-case basis and look at service quality, if we had had some kind of trigger. But it is very difficult to do that.

So, the answer to your question is I think there will be an incentive to let service quality lapse in some areas and for some customers, even as there is an incentive complementary to that to beef up quality of service in other areas for other customers. The real problem will be equal opportunity of service quality, so to speak, under a price cap regime.

Senator INOUYE. It appears that the FCC price cap proposal relies upon, to some degree, the British experience with Telecom. How would you compare the British Telecom with our companies? Are they more efficient? Are they more productive than American companies?

Ms. SCHWARTZ. My only first-hand experience with British Telecom is not really first-hand. It is second-hand.

My sister and brother-in-law live in London, and they just arrived for their annual visit. When I told them that I was going to speak on the merits of British Telecom, they both threw up their hands in horror and said well, tell the Senators that it absolutely is terrible and for the past three years the quality of service has been going rapidly downward.

Now, they are small, residential customers, and an N of one is never acceptable by any researcher.

I think the environment was so different when price caps were implemented. The British system was extremely inefficient, and there was no demonstrated urge for competition within that system. They were trying to get out from under the heavy yoke of a state regulated, bureaucratic setup. Therefore, the incentives that they promulgated need have been excessive, perhaps, in order to get that energy going in that system.

But I don't think that the competition that they expected has materialized. It is definitely in very limited niche markets, which constitute cream skimming, and the residential rate payers' service quality has been written about extensively as not being particularly something to be emulated.

Senator INOUYE. How does the level of service quality, the level of efficiency, the level of productivity of American telephone companies compare with telephone companies anywhere else in the world, say, with the Japanese, the French, the Germans, or the Italians?

Ms. SCHWARTZ. I believe, Senator, that we have always set the standard for other countries and that there is no evidence that anything in recent history has destroyed our relative position as the Nation that developed a continental telephone network. Even though some of the fallout from divestiture has caused some trouble in some areas and a great deal of consumer confusion, there is no evidence that the technical quality of the system has deteriorated or that there are perverse incentives within the new regulatory environment that would expect that this would deteriorate, other than the fact that large companies seek to invest overseas and may be diverting capital from the domestic industry, which I do not think the price cap regime is going to affect very much. The growth of overseas markets is not going to be affected by a price cap regime.

Ms. NELSON. I would just echo that I think our actual performance remains second to none. In the future, going forward with the

new arrangements, we may need to be paying attention to quality of service standards; we may need to be more active in participating in international standard setting bodies and the like, so that our performance remains absolutely superior in international comparisons.

Senator INOUYE. So, American consumers are getting a better deal than any other consumers in the world?

Ms. SCHWARTZ. One has that impression, yes. I travel fairly regularly, and, although I cannot use the Japanese telephone system because I do not speak Japanese, I have used telephone systems in other countries where I do speak the language, and I think that the lag time between the time you dial and the time you get your party, your connection, is greater in other advanced industrial countries than it is here; and the likelihood of getting your call competed is greater in this country than it is there.

So I don't think there is any evidence that we are slipping, technologically speaking, in service quality.

Senator INOUYE. Well, is it your contention "why mess around when the situation is good?"

Ms. SCHWARTZ. I believe that there is a very good reason to move away from traditional cost-based rate of return regulation, where it is possible to do that by establishing a true incentive for the company to be efficient, and a true benefit for the consumer to gain from those efficiencies, because I do believe that the opportunity for higher earnings, if tempered with a monitoring system that will look at service—and I would suggest that what we need at the inter-exchange level is to identify certain critical services that are likely to be affected by a price cap regime and monitor those very closely. They probably would be the less competitive services because that is where there would be an incentive created to let quality slip, since the customers could not leave and go to another provider.

I do believe that there is good reason to consider an incentive regime that would be superior, in that regard, to traditional rate of return regulation. But I believe equally strongly that we have to pass those benefits through to the rate payer as they are realized, not in some hypothetical fashion as the FCC proposal does, and not based only on history, because, presumably, the productivity gains historically are much less than those we can anticipate under an incentive regime.

Senator INOUYE. Ms. Nelson, do you have anything to add?

Ms. NELSON. I would just add to that that there is always room for improvement. I think it is important to emphasize the difference between the New York plan, which many of us are examining with great interest, and the FCC's proposal.

The New York plan is an absolute cap, not an index rise, and the sharing of benefits occurs with reference to the achieving of a certain level of return. That rate of return remains a key element in the New York plan. When that return is achieved by the company, then the sharing of the benefits begins. So it is a key element of that plan. It is not just discarded with notions that eventually three years, four years, or five years from now, rates will be adjusted downward, if necessary.

Ms. SCHWARTZ. May I make just one last comment, Mr. Chairman, on the question of optionality? That, to my view, is an utterly unacceptable way to regulate. If we need regulation, then we need regulators who are able to choose what the best method in the public interest is, and it either is or is not price caps. But I don't believe the "regulatee" should have the option of choosing.

Senator INOUYE. Would it take more than a staff of 34 to monitor the New York plan?

Ms. SCHWARTZ. Oh, yes. It would, indeed—for all the companies in the United States, were they to be imposed? Is that what you mean, Mr. Chairman, or in New York?

Senator INOUYE. Well, Chairman Patrick indicated that his staff numbers 34. I am just wondering what can he do with a staff of 34.

Ms. SCHWARTZ. Well, I guess I owe Chairman Patrick a bouquet for having complimented the New York plan, so I will give him one now and say that I think the FCC would definitely need a larger force to monitor service quality under price cap regulation. But I also believe that perhaps the deployment of resources under the present regime could be reexamined because it does not strike me that 34 people to monitor service quality for a carrier as large as AT&T is excessive, or sufficient.

Senator INOUYE. How large is the New York staff?

Ms. SCHWARTZ. Oh, I was afraid you were going to ask me that. I do not know how many people are doing service quality monitoring, but I will get the answer for you, this morning, if possible.

Senator INOUYE. Ladies, I thank you.

Ms. NELSON. May I just extend this one more minute to answer that question? It might be helpful for the record.

Senator INOUYE. Yes.

Ms. NELSON. We have five accountants at the Washington Commission who, thus far, have been able to take care of rate based rate of return kinds of rate cases for the 25 companies we regulate.

Now, I am not saying how well we do that, but they have been able to cope up until now. I think Gail's point about monitoring service and the requirements that will be imposed on the FCC under its proposed plan are things that need to be considered. Administrative resources that might be required might be very vast, indeed. And there are other good ideas in the literature and in the State jurisdictions about how we might achieve the goals of simplifying regulation, how we might achieve the goals of getting some carriers that do not need to be regulated in the first place out of the hearing rooms, and about how we might better accommodate many of the interests and the needs of this dynamic industry.

So I think there is no monopoly on good ideas. I think that is the point of our testimony here today, that this proposal needs a lot more refinement.

Ms. SCHWARTZ. We have about 20 people in our Communications Division, and we have about 10 or 15 in our Accounting and Finance Division. But how many are doing service quality, I am not exactly sure. We have many divisions who work on different aspects of the communications regulation from different sections of the organization.

But I will get that answer to you. Thank you very much, Mr. Chairman.

Senator INOUYE. Ladies, I thank you very much. You have been extremely helpful.

Ms. NELSON. Thank you.

Ms. SCHWARTZ. Thank you, Mr. Chairman.

Senator INOUYE. Usually at this time the Committee would recess for lunch. But if we did that, this hearing would have to be postponed until another day. So, if you don't mind, we will go on a diet today.

Our second panel consists of the Vice Chairman of AT&T, Mr. Charles Marshall; the President of MCI, Mr. Bert Roberts; the President of Southern Bell, Mr. Frank Skinner; the First Vice President of United States Telephone Association, Mr. Alan C. Hasselwander; the General Manager of Grand River Mutual Telephone Corporation, Mr. Robert C. McArton; the Public Counsel of the State of Florida, Mr. Jack Shreve; the People's Counsel of the State of Maryland, Mr. John Glynn; and the President of the Communications Workers of America, Mr. Morton Bahr.

I am told that Mr. Gerry Kovach will be representing Mr. Bert Roberts of MCI.

I would like to now call upon the Vice Chairman of AT&T, Mr. Marshall.

STATEMENT OF CHARLES MARSHALL, VICE CHAIRMAN OF THE BOARD, AT&T

Mr. MARSHALL. Thank you, Mr. Chairman. Also, I appreciate our going on the diet. I think that fits all of our schedules very nicely, particularly mine.

I appreciate the opportunity to share with you the reality of competition in our industry today, the regulation of AT&T and the need for reform.

The long distance market is vigorously competitive. More than 500 competitive carriers serve this market, with no fewer than 12 in any one State and several larger facility-based carriers competing almost everywhere across the country.

As the FCC reports indicate, competition has driven AT&T's market share from nearly 85 percent in mid-1984, to less than 70 percent by the end of 1987. MCI, Sprint, and AT&T each has sufficient capacity to carry the entire interstate demand on any one of our networks.

There are a number of noncommon carriers who are nonregulated, such as Teleconnect, Light Net, and others, and, on top of the capacity that the three have, these firms add alternative capacity and choice to the consumer. This intense level of competition drives prices toward costs and prevents AT&T from raising prices above market determined rates. Rational regulation must reflect the dynamics of this competitive market so that consumers will benefit.

Regulation must not impede the flow of technology and the flow of innovation for the Bell Telephone Laboratories, as has been the case too often in the past few years.

Having been relieved of both direct earnings and price regulation, AT&T's competitors now compete freely and successfully. It is

imperative that the Commission allow AT&T to compete on the same basis.

The Commission should immediately replace rate of return regulation of AT&T with ongoing regulatory oversight and a streamlined tariff review process. The Commission also can supplement its oversight and address specific public concerns, such as continued service in rural areas, geographic rate averaging, and full resale and sharing.

As a transition to the same regulatory scheme governing our competitors, AT&T supports the Commission's efforts to replace rate of return regulation with price caps. The FCC price cap plan holds the promise for incentives to produce efficiency and consumer benefit. But, unfortunately, intrusive price controls over AT&T have crept into the plan.

Most fundamental, the Commission should delete the artificial restriction of competitive price reductions and afford streamlined tariff review to allow all price decreases.

Without this modification, competition will be impeded and consumers will be harmed by a delay or a denial of the lower prices they should expect.

The commission should not impose pricing restrictions or banding on AT&T's some 60,000 separate rate elements. These intrusive price controls are a step backwards, and they provide AT&T even less pricing flexibility and less ability to compete than today.

The price controls would impose additional and unnecessary administrative costs on AT&T and on its customers.

Mr. Chairman, one of the mandates of the long distance market which AT&T must continue to follow is differentiation of our services on the basis of quality and responsiveness to technological innovation. Competitors have begun to recognize that quality of service is an attribute that they must strive to achieve, whatever the regulatory structure.

But price caps are not. The competitive market will punish any provider who allows quality to deteriorate.

AT&T, as the largest access customer of the local exchange companies, does not oppose the concept of alternative to rate base regulation for those companies. However, while the Commission recognizes the absence of competition for the local exchange companies, the plan does not appear to recognize this difference in market conditions. The plan should provide adequate assurance that access rates will fall with increased volumes that drive declining costs; that access customers will have protection against improper strategic pricing; and that all customers will benefit from expected increases in productivity of the local exchange companies.

These concerns must be addressed in modification of the plan, to assure consumers will benefit under the alternative structure for the LECs.

Regulatory reform of AT&T is long past-due. Competition was introduced in our market more than 20 years ago. The monopoly model for long distance was shattered long ago, and competition was defined as a model which would best serve this public's interest.

But, even though the long distance market is now effectively competitive, AT&T is still regulated in stringent monopoly terms.

If consumers are truly to benefit from competition, then AT&T must not be excluded from being a viable choice. That is what regulation is doing today. The Commission must take the next step now to initiate the reformed regulation of AT&T and thus bring consumers the benefits of lower prices, quality service, and choice that only full competition can bring.

Thank you, Mr. Chairman.

[The statement and questions and answers follow:]

STATEMENT OF CHARLES MARSHALL, VICE CHAIRMAN OF THE BOARD, AT&T

Mr. Chairman and members of the subcommittee. My name is Charles Marshall. I am Vice Chairman of the Board of American Telephone and Telegraph Company ("AT&T"). We greatly appreciate the Committee's invitation to discuss the Federal Communications Commission's ("FCC") proposed plan to replace rate of return regulation of AT&T and the Local Exchange Carriers ("LECs") with a system of price caps and a streamlining of the regulatory procedures. The FCC's proposed plan was detailed in its Further Notice of Proposed Rulemaking of May 23, 1988. AT&T believes that regulatory reform, the stated objective of the FCC's proposal, is long overdue to reflect the competitive nature of interexchange telecommunications in 1988.

As the Federal Communications Commission found in its Further Notice, the interexchange market is vigorously competitive. Recent FCC reports reveal that AT&T's market share has declined substantially from mid-1984, from some 84.2 percent to less than 70 percent at the end of 1987.

This rate of decline, even more than the particular static percentages of market share, conclusively demonstrate the highly competitive nature of the interexchange market. The interexchange market is currently populated by more than 500 competing carriers, with no fewer than 12 carriers competing in any state, and several major facilities-based carriers competing almost everywhere. This competition greatly constrains may market power AT&T may have had in the past. Equally important, the evidence indicates that there will be continued, indeed heightened, interstate interexchange competition in the future, including the extensive deployment of competing fiber optic networks. Today, each of the major long distance carriers—AT&T, MCI and Sprint, has enough sunk capacity to carry the entire nation's long distance calling.

Moreover, the overall market data if anything understates the degree of competition in the most vigorously contested part of the market—competition for the largest business customers. Those customers are readily identifiable, generate enormous long distance revenues, and are extremely sophisticated in pursuing quality service arrangements at the lowest possible cost, often through competitive bidding or equivalent procedures. As both the National Telecommunications and Information Administration and Department of Justice concluded in comments filed before the FCC the interexchange market is now "effectively competitive."

Rational regulation must reflect that competition. Because AT&T's competitors effectively compete with AT&T, regulation must permit AT&T to compete with them. It has become manifestly clear, however, that the FCC's policy of forbearing from applying full regulation to AT&T's competitors while continuing full tariff regulation of AT&T frustrates, rather than promotes competition, and harms, rather than benefits consumers.

The reform the long distance industry badly needs is not intrusive price controls over AT&T's services but forbearance from Title II regulation of AT&T to the same extent the FCC long ago extended such treatment to AT&T's competitors. Having been relieved of both direct earnings and price regulation, AT&T's competitors now compete freely and successfully for all business in the interexchange market. It remains only for the FCC to allow AT&T to compete on the same basis. Such forbearance, together with the FCC's ongoing oversight supplemented with carefully targeted regulatory controls—*e.g.*, prohibitions of geographic de-averaging [1] and of restric-

[1] The most likely cause of geographic rate de-averaging is not price cap regulation, but the de-averaging of access rates, which account for almost 50 percent of interexchange carrier costs. AT&T is committed to continuing geographic of toll rates, but any further deaveraging of the rates for exchange access authorized by the Commission would logically require that AT&T have the flexibility to de-average interexchange rates to reflect those access costs, at least to the extent interexchanging competition requires.

tions on resale and sharing—will enhance competition and benefit consumers far more effectively than continued one-sided tariff restrictions on AT&T's ability to compete.

The FCC, however, proposes to replace rate of return regulation with a system of price caps. Although a price cap approach is almost assuredly better than rate of return regulation—for consumers and the industry alike—it is decidedly inferior to an approach placing greater reliance on competitive market forces. As the numerous issues raised by the Further Notice make clear, a regime of price caps risks replacing one cumbersome and costly process with another. Any price cap regulation of AT&T should, accordingly, be adopted as a transition to a market oversight approach and should be designed to interfere as little as possible with the market forces that are the best assurances that consumers will receive the benefits promised to them by the Communications Act.

In its initial comments filed on July 26, 1988 with the FCC, AT&T has responded in detail to the various issues raised by the Further Notice. AT&T believes that if the FCC's price cap plan is modified to take adequate account of the competitive conditions in the interexchange market, it will serve as a superior alternative to rate of return regulation and a helpful transition to the appropriate regulatory oversight of AT&T.

A properly designed price cap plan would not only afford customers significant new protection against price increases, but would in all probability result in greater price decreases (or small price increases) than would result under rate of return regulation. Such a price cap system would release the incentives to innovation and efficiency that are suppressed by rate of return regulation, increasing the availability of new services and lowering prices. By allowing rates to be set by competitive forces rather than arbitrary cost allocations, price caps also would increase efficiency and avoid the waste of misallocated resources, while better protecting consumers against any perceived risk of cost-shifting and cross-subsidy.

If modified, the proposed plan can achieve these enormous consumer benefits. Most fundamental, the FCC should delete from its price cap plan the artificial restrictions on competitive price reductions and afford streamlined tariff review to all price decreases. Without this modification, competition will be impeded and customers will be harmed by delaying or denying them lower prices. The FCC should also not impose pricing restrictions on AT&T's thousands of separate rate elements. These extreme and instrusive price controls are a step backwards and provide AT&T even less pricing flexibility and less ability to compete than it has today. This would impose enormous administrative costs on AT&T and its customers.

The FCC tentatively proposes to employ a combination of "baskets" and "bands" to achieve the goals of price cap regulation. The two proposed baskets—by themselves—would amply protect customers against unreasonable prices. The cap on each basket, as periodically adjusted, would ensure that overall prices fall in real terms over time, as increased productivity lowers competitive costs. Competition would keep individual service prices aligned with costs, preventing any specific price from being set too high or "subsidizing" other services. Thus, had the Commission confined its pricing restrictions to the two caps, it would have achieved the proper balance it sought between protecting ratepayers and allowing AT&T needed pricing flexibility.

Under the Commission's plan, however, only price changes within the proposed $\pm 5\%$ bands would be eligible for streamlined tariff review procedures and only price reductions that remain above the lower band limits would be "credited" for purposes of determining compliance with the overall cap. The bands have no proper place in the Commission's reformed regulation of AT&T.

By design, the impediments to price decreases in excess of 5% would make it significantly more difficult (as well as less attractive) to give consumers large price reductions as opposed to merely small ones or none at all. These impediments, and the disparity in treatment they create, would inevitably delay or even prevent price reductions entirely and, to that extent, operate as an artificial price floor.

These price floors are anti-comsumer and out of place in a reform intended primarily for their benefit. As Professor Areeda, the nation's leading antitrust scholar, and Dr. Klein, Nobel Laureate in Economics, demonstrate in their attached supporting statements, such restrictions—like a 5 percent lower price bound—harm consumers by impeding wholly legitimate price reductions. Customers are unequivocally benefitted by price decreases, not price rigidity, and their welfare is maximized if competition drives prices down to incremental cost. Any restriction, such as the 5% lower bound, that would hold prices above that level simply erects an artificial price umbrella, distorts competition, and forces ratepayers to pay needlessly higher prices.

Indeed, the lower price bands would often have the even more anomalous—and anti-consumer—effect of requiring AT&T to increase rates. Because the midpoint of each band moves in conjunction with the price cap index (the "PCI"), an increase in the PCI that shifts the bands above existing rates would require AT&T to raise rates in order to stay within band.[2] Thus, even if AT&T did not wish to raise rates, the Commission's proposal could require rate increases. Elimination of the lower band limits would avoid this unintended and anti-consumer result.

Artificial price floors are also totally unnecessary to address the concern that AT&T might set prices too low. As the FCC recognizes, prices can be "too low" only if they are below incremental costs. The FCC also recognizes that such predatory below-cost pricing is a credible concern only if the seller can realistically drive its competitors from the market and then recoup its predatory losses by later raising prices above competitive levels.[3]

There is no such possibility in the long distance market. The large number of competitors, including numerous national and regional facilities-based carriers with enormous sunk network capacity makes the prospect of successful predation utterly remote. AT&T could neither drive its competitors out of business and sustain the losses of attempting to do so, nor keep its competitors out of the market while trying to recover its losses through supra-competitive prices. Moreover, the price caps themselves, and the FCC's continued monitoring of the interexchange market, provide additional adequate safeguards against anticompetitive pricing.

As to price increases, competition in the interexchange market will continue—as it does now—to prevent AT&T from sustaining individual service prices above competitive levels. Thus, to the extent that AT&T would raise a service or rate element price above band, it could only do so if compelled and justified by the market. If the Commission were concerned that competition for a certain service (for example, basic Message Toll Service) would not be sufficient to preclude unreasonably high prices, it might consider restricting for a limited period price increases on basic MTS or even three upper bounds—one each for day, evening, and night/weekend. This would afford customers additional price protection without the burden and complexity of rate-element specific price bands. In this way, the Commission's concerns would be assuaged, consumers would be protected and AT&T would be afforded the opportunity to demonstrate further that upper price bounds are wholly unnecessary in today's interexchange market.

As originally conceived, one of the primary objectives of price cap reform was to streamline the tariff review process. As the Commission recognized, current tariff review procedures are administratively costly, and often impede wholly legitimate tariff offerings. Thus, streamlined review for tariff filings below the price caps, including shortened (14-day) notice, a presumption of lawfulness, and the elimination of extensive supporting documentation—procedures the Commission has long applied to AT&T's competitors—was viewed as appropriate for AT&T.

The Further Notice, however, retreats significantly from the reforms as originally conceived. Under the FCC's proposal, streamlined review would be denied price changes outside the band and above the cap, and new services and restructured services. Virtually none of AT&T's filings since divestiture would qualify for streamlined review under the proposed plan.

The failure to extend streamlining more broadly would curtail the potential benefits of price caps. Artificially narrow regulatory restraints—such as streamlining only for rate level changes within the limits proposed by the Commission—would only perpetuate the delay and costs of existing regulation, handicapping AT&T's ability to compete with carriers long free of such requirements. Such asymmetric regulatory treatment creates a significant and unfair competitive disadvantage for AT&T, encourages competitors to "gameplay" with regulatory procedures and ultimately denies consumers the full benefits of competition.

The FCC proposes that price changes above the bank or cap would be presumtively subject to suspension, and must be filed on 90 days' notice, a longer notice period than required today. In addition, the FCC proposes that price increases above the bank satisfy a "substantial cause" standard that appears more onerous than that which AT&T must meet for price increases today, and above-cap standard that appears virtually impossible to satisfy. Hence, rather than a step toward reduced regu-

---

[2] Further Notice, ¶ 307. Even when an increase in the PCI is not sufficient to shift bands completely above rates, it would raise the bands, leaving AT&T less than 5% downward price flexibility in the following year.

[3] Further Notice, ¶ 290; *See also, Matsushita Electric Industrial Co.* v. *Zenith Radio Corp.*, 106 S.Ct. 1348 (1986).

lation for AT&T, the proposed plan takes a step backward and imposes even more onerours regulation than currently exists.

Moreover, the FCC's failure to extend streamlined tariff treatment to restructured any new services denies streamlining to those very filings developed in response to, and necessary to compete effectively in, a market as vigorously competitive and dynamic as the interexchange market. Thus, the FCC's proposed plan denies streamlining to some of the services most deserving of expedited review, and, in certain instances, imposes more onerous regulation on AT&T than currently exists.

Furthermore, due to the proposed plan's banding of every rate element, rate level changes may be denied streamlined tariff review even where the service price changes less than 5 percent. There is no justification—from the customer's point of view or otherwise—for this patently unreasonable result. Customers are concerned with the price they pay for a service, not with the "prices" for thousands of constituent rate elements they would never buy or use separately. In addition, elimination of rate element bands would spare customers and carriers alike the enormous and gratuitous cost of tracking the bands for AT&T's 60,000 rate elements. The administrative burden of doing it is wholly at odds with the Commission's stated goal of simplifying and avoiding unnecessary costs of regulation.

Contrary to concerns that a price cap system might lead to a deterioration in service quality, price cap incentives will actually enhance service quality by stimulating technological innovation. Moreover, the presence of numerous well-financed competitors offering a complete range of services that employ state-of-the-art facilities assures that AT&T must continue to offer the highest quality service possible, or suffer the loss of customer's business. Thus, a properly designed price cap scheme will only enhance AT&T's tradition of outstanding service in the telecommunications industry.

Finally, AT&T does not oppose the concept of alternatives to rate of return regulation for local exchange carriers. But just as the FCC's proposed plan does not adequately accommodate competition in the interexchange market, it appears to take inadequate account of the absence of competition in the provision of access services. The plan should provide adequate assurances that access rates will fall with declining costs and that access customers will have protection against improper strategic pricing and will receive the benefits of expectable increase in local exchange carriers' productivity.

In particular, the FCC must be especially careful in setting rules for regulation of Carrier Common Line ("CCL") charges, which are far and away the largest component of interstate access expense, comprising, along with the subscriber line charge, about forty percent of the average customer's monthly interstate long distance bill. Since the CCL charge recovers non-traffic sensitive costs, the unit costs of CCL decline dramatically with increases in traffic. The proposed plan must be modified to assure that consumers will recover fully the substantial benefit of their own increased calling, as they have under rate of return regulation. As proposed, the FCC's plan would deny consumers that benefit and leave them far worse off than under rate of return regulation.

In addition, a price cap plan for the local exchange carriers must include procedures that substitute for market forces to assure reasonable rate levels, guarantee non-discriminatory pricing, and protect against cross-subsidies. AT&T has presented suggested modifications to the FCC's plan in its initial comments that would satisfy these concerns.

QUESTIONS OF SENATOR PRESSLER AND THE ANSWERS

Question. Would you remain committed to geographic toll rate averaging if you were to be regulated under price caps?

Question. Do you think price caps provide more incentives to deaverage than cost-of-service/rate-of-return regulation?

Answer. The answer to both questions is that implementation of price cap regulation will in no way impair the FCC policy of geographic rate averaging or AT&T's commitment to that policy. Nor will a price cap form of regulation change incentives to deaverage.

The support for geographic rate averaging arises not from how AT&T is regulated, but from other FCC policies and rules, including support for high cost exchange areas and the averaging of exchange carrier access charges. The averaging of exchange carrier access charges is scheduled to end on April 1, 1989. In its place, the FCC has implemented further support for high cost exchange areas, including long-

term support that ensures that the small carriers who elect to remain in the nationwide pool have the same rates they would have had if mandatory pooling for all exchange carriers had continued. The FCC has the power to implement further measures if reguired to control variations in access rates that could threaten nationwide averaging of long distance rates.

One can anticipate that increased variation in access rates after April 1, 1989 could lead to attempts by AT&T's competitors to obtain a marketplace advantage. If this occurred and AT&T was not permitted to compete, it would mean lost business and impaired ability to serve customers in high access cost areas at averaged rates. However, AT&T does not seek to deaverage rates; we are committed to the principle of nationwide averaging. We depend on the FCC to control the variation in exchange carrier access charges so that nationwide averaged long distance rates remain a marketplace reality.

Senator INOUYE. I thank you very much, Mr. Marshall.

If I may, I would like to call upon all of you before I ask questions.

Now, if I may, I would call on Mr. Kovach.

STATEMENT OF GERALD J. KOVACH, SENIOR VICE PRESIDENT, MCI COMMUNICATIONS CORP.

Mr. KOVACH. Good afternoon, Mr. Chairman. My name is Gerry Kovach. I am Senior Vice President of Regulatory and Public Policy, MCI Communications Corporation. I am pleased to be here today to express MCI's concerns about the FCC's price cap proposal.

Comments we filed at the FCC last week state a simple fact: MCI is opposed to the price cap regime, as currently proposed by the Commission.

The long distance telecommunications market and the local exchange access market differ in profound ways. The long distance market is becoming competitive. The local exchange market is, and will remain, a classic public utility monopoly.

In spite of these differences, the FCC plans to apply price caps to both. This makes no sense. The FCC's proposal would allow local exchange carriers to charge excessive prices and discriminate among their customers. At the same time, the proposal ignores fundamental competitive issues in the inter-exchange market.

MCI's greatest concern is with the application of the FCC's price cap proposal to LECs.

We would like to Commission to focus on a simple question: if the price cap proposal is so great for consumers, why do so many consumers oppose it? Are the people who pay the bills suffering from myopia, or has the FCC failed to focus on and come to grips with the real issues confronting this industry?

Price caps for LECs are bad for long distance carriers, bad for our customers, and bad for your constituents. LEC price caps would undoubtedly result in excessively high access charges. The Commission proposes to use existing LEC rates as a starting point for price caps.

But LECs are currently being allowed by the FCC to earn a rate of return that is too high. Even worse, the FCC is allowing many LECs to earn in excess of the already too-generous return.

The FCC points out that rate of return regulation of local carriers is not working to protect consumers. We agree.

But it seems that the problem lies not with the institution of rate of return regulation, but with the regulators themselves.

Price caps will not only allow LECs to continue to charge today's excessive rates, they will fail to reflect future cost savings in local exchange networks.

It is hard to imagine companies with greater market power than the LECs. The ability to change prices with virtually no regulatory oversight or competitive market pressures would give LECs an unbridled capacity to use their market power unfairly against consumers.

We believe that rate of return regulation of the local exchange market, even with its flaws and distortions, should be allowed to continue to bring large benefits to consumers. The Commission's price cap proposal will only serve to lock in high rates, deny consumers the benefits of coming cost reductions, and provide LECs with unprecedented and unwarranted discretion over prices.

In our comments filed at the FCC last week, we provided several suggestions for improving the price cap proposal for AT&T. But the major issue we raised in those comments was that the FCC has taken its eye off the ball. The single most important issue in the inter-exchange business today is AT&T pricing plans that violate the Communications Act.

Instead of enforcing regulations that will insure the continued development of a competitive inter-exchange industry, the Commission has decided to put its resources into developing another form of regulation for AT&T—price caps.

Customers of both MCI and AT&T are benefitting from the existing competition and will benefit even more as the market becomes more competitive. This will be true under price cap regulation or under continued rate of return regulation only if the Commission enforces its long-standing rules, regulations, and policies that are designed to prevent unfair competition by dominant carriers.

AT&T complains that its tariff filings are occasionally rejected or investigated. What AT&T is really telling you is that it does not want the FCC to do the job that the Congress has given it.

Further, AT&T complains that regulatory constraints somehow prevent them from competing effectively—strange talk from a company that, according to its own Treasurer, still retains an 80 percent share of the market.

In conclusion, price caps are not the magic solution to all of our problems in telecommunications. The Commission should not be allowed to substitute mechanical formulas for the kind of oversight that is needed over LECs, and it should not be allowed to walk away from those competitive problems that remain to be solved in the inter-exchange industry.

Price caps for LECs will harm consumers and competition. Price caps for AT&T do not address the real issues in the industry today.

Thank you.

[The statement follows:]

STATEMENT OF GERALD J. KOVACH, SENIOR VICE PRESIDENT, MCI COMMUNICATIONS CORP.

Good morning Mr. Chairman and Members of the Subcommittee. My name is Gerald Kovach. I am Senior Vice President of Regulatory and Public Policy, MCI Communications Corporation. I am pleased to be here today to express MCI's concerns about the FCC's price cap proposal.

The comments we filed at the FCC last week state a simple fact. MCI is opposed to the price cap regime as currently proposed by the Commission.

The long distance telecommunications market and the local exchange access market differ in profound ways. The long distance market is becoming competitive; the local exchange market is, and will remain, a classic public utility monopoly.

In spite of these differences, the FCC plans to apply price caps to both. This makes no sense. The FCC's proposal would allow the monopoly local exchange carriers to charge excessive prices and discriminate among their customers. At the same time, the proposal ignores fundamental competitive issues in the interexchange market.

MCI's greatest concern is with the application of the FCC's price cap proposal to monopoly local exchange carriers. Before addressing the specific problems with applying the FCC's proposal to the local exchange carriers, I want to explain why this issue is so important to MCI.

MCI is a large consumer of local exchange carrier access services—in fact we are the second largest consumer. MCI is currently paying local exchange carriers well over two billion dollars per year for access charges. Put another way, close to 50 percent of our revenue dollar goes directly to the local exchange carriers. It is the rates MCI must pay to monopoly local exchange carriers that the FCC is proposing to cap.

The Commission believes that price caps will provide benefits to consumers. The Commission talks about resource savings and enormous productivity benefits. Based upon a reading of the FCC's proposal, one gets the impression that price caps can do everything but predict a winner in the coming presidential campaign.

We would like the Commission to focus on a simple question: if the price cap proposal is so great for consumers, why do so many consumers oppose it? Are the people who pay the bills suffering from myopia—or has the FCC failed to focus on and come to grips with the real issues confronting this industry?

Price caps for monopoly local exchange carriers are bad for long distance carriers, and ultimately bad for our customers, your constituents.

Perhaps the most troubling problem with the FCC's proposal is that local exchange carrier price caps would undoubtedly result in excessively high access charges. The Commission proposes to use existing local exchange carrier rates as the starting point for price caps. But local exchange carriers are currently being allowed by the FCC to earn a rate of return that is too high. Even worse, the FCC is allowing many local exchange carriers to earn in excess of the already-too-generous return. Reports filed at the Commission by local exchange carriers show overearnings of more than 300 million dollars since the beginning of 1987.

Moreover, these local exchange carriers earnings are based on inflated capital investment and expenses, which even the FCC and some of the local exchange carriers recognize.

The FCC points out that rate-of-return regulation of local carriers is not working to protect consumers. We agree. But it seems that the problem lies not with the institution of rate of return regulation—but with the regulators themselves. A review of actual rate cases over the past four years bears this out. In the states, where commissions have continued to investigate local exchange carrier rates, rate requests have dropped dramatically. Just last week, the FCC reported that "during the first six months of 1988, rate reductions and refunds ordered by state commissions continued to exceed the dollar amount of rate increases granted." And more importantly, state after state has begun to reexamine the current overearnings situations and subject local exchange carriers to traditional rate of return scrutiny—rejecting the "quick-fix" of price caps or rate moratoriums.

Price caps will not only allow monopoly local exchange carriers to continue to charge today's excessive rates, they will fail to reflect future cost-savings in local exchange networks. The future should bring enormous productivity gains to the local exchange. These gains will come from the introduction of new switching and transmission technology in the local exchange and from rapid growth in demand. The Commission's price cap proposal will not capture these gains for consumers. Apparently the local exchange carriers do not want to share with consumers the cost savings inherent in these new technologies—preferring instead to keep the profits.

Another significant problem we have with the proposal is that the Commission would apply "streamlined regulation" to most local exchange carrier rate changes. Streamlined regulation would allow local exchange carriers to move rates up or down with only a fourteen day notice period, no obligation to provide supporting cost information, and a rubber stamp presumption of lawfulness. Consumers would have virtually no ability to protest tariffs filed under this standard. This scheme

invites the sort of unreasonable discrimination and cross-subsidy that the Communications Act was designed to prevent.

Streamlined regulation was developed by the Commission for competitive carriers. The original theory underlying streamlined regulation was that carriers lacking market power are unable to charge high prices or discriminate unreasonably.

In other words, because they do not have market power, non-dominant carriers can be subjected to a reduced level of regulation.

It is hard to imagine companies with greater market power than local exchange carriers. The ability to change prices with virtually no regulatory oversight or competitive market pressures would give local exchange carriers an unbridled capacity to use their market power unfairly against consumers. There are numerous ways in which the monopoly local exchange carriers can use their market power to discriminate against customers.

For example, because of differences in the size and configuration of their networks, newer entrants into the long distance market buy substantially different mixes of services from the local exchange carriers than does AT&T. Installation charges and special access are relatively much more important to MCI than to AT&T. Unjustified increases in these access services could reduce interexchange market competition. AT&T continues to market WATS services and 800 services jointly with the local exchange carriers even four and one-half years after divestiture. Under the FCC's proposal, in a period of just over twelve months, the local exchange carriers could reduce prices for services they want to promote and raise the prices of services they want to retard by 10 percent each—a differential of over 20 percent—and there would be no requirement to cost-justify these changes.

The threat of large, non-cost based changes in rates would introduce enormous uncertainty into all of the access dependent industries. Moreover, the ability of the local exchange carriers to move individual service prices away from costs will reduce economic efficiency, which is supposedly one of the goals of price caps. At the FCC, local exchange carriers are already being allowed to earn a rate of return on high capacity special access of up to 40 percent. Problems such as this one would only grow worse under price caps.

Claims that the deregulation caused by the FCC's price banding proposal is necessary in order to prevent bypass are simply untrue. Demand for local exchange carrier switched access services is rising rapidly. The specter of wholesale desertion of the public switched network by the long distance carriers never materialized. The fact that many local exchange carriers are willing to price high capacity special access at enormous rates of return prove that they are unconcerned about facilities bypass.

In its testimony last week, Bell Atlantic claimed that the fire which recently destroyed an Illinois Bell switch proves that facilities bypass is a real threat. The opposite is true. Of all the thousands of MIC and AT&T customers whose local service and access to long distance service was interrupted by that fire, only a handful were able to take advantage of emergency microwave facilities. Line of sight to, and limited distance from, an interexchange carrier facility was required to provide this service. Moreover, if this alternative made economic sense, it would have occurred before the fire and not after it. Finally, providing emergency service to our customers in this situation was not bypass of the local network—there was no local network after that fire.

In sum, we believe that rate-of-return regulation of the monopoly local exchange market, even with its flaws and distortions, can and should be allowed to continue to bring large benefits to consumers. These benefits are being proved out in those states which continue to take the job of regulating the local exchange carrier seriously. The Commission's price cap proposal, on the other hand, will only serve to lock in high rates, deny consumers the benefits of coming cost reductions, and provide local exchange carriers with unprecedented and unwarranted discretion over prices.

The problems with applying price caps to AT&T are less severe. In our comments filed at the FCC last week we provided several suggestions for improving the rate cap proposal for AT&T. But the major issue we raised in those comments was that the FCC has taken its eye off the ball. The single most important issue in the interexchange business today is AT&T pricing plans that violate the Communications Act. Instead of enforcing regulations that will ensure the continued development of a competitive interexchange industry, the Commission has decided to put its resources into developing another form of monopoly regulation for AT&T.

MCI's recent financial performance demonstrates without a doubt that competition is here to stay in the interexchange market. Intelligent regulation will allow even more competition to develop. The customers of both MCI and AT&T are bene-

fiting from the existing competition and will benefit even more as the market becomes more competitive. This will be true under price cap regulation or under continued rate of return regulation—as long as the Commission enforces its longstanding rules, regulations and policies that are designed to prevent unfair competition by dominant carriers. These rules include resale, unbundling, and the full application of the tariff process.

AT&T likes to complain that these market rules that MCI would like the FCC to enforce are anticompetitive. AT&T claims that intervention at the FCC by MCI and other carriers is intended only to forestall rate reductions that would benefit consumers. AT&T is simply trying to deflect attention from the fact that it is filing tariffs which raise substantial concern that Communications Act is being violated.

The Communications Act already gives dominant carriers a large advantage over consumers and competitors. The standard for rejection is "patent illegality." This is a difficult standard to meet when challenging a carrier-initiated tariff change. Once a tariff containing unlawful rates becomes effective, it is virtually impossible to get a Court review. Finally, it is not MCI or any other carrier or customer who decides that tariffs should be rejected or suspended and investigated—It is the FCC. If AT&T does not want opposition to its tariffs, then from MCI's point of view, all AT&T has to do is stay away from the boundary that separates patent illegality from lawfulness. What AT&T is really telling you when it complains about the tariff process is that it does not want the FCC to do the job that the Congress has given it.

AT&T would have you believe that competitors such as MCI have all of the advantages in today's marketplace. AT&T forgets that only AT&T has available to it univeral equal access, a public payphone monopoly, account control of a large segment of the embeded base of 800 customers, exclusive contractual arrangements with the local exchange carriers known as Shared Network Facilities Agreements (SNFAs), operating argeements world-wide or international service, and a network built and paid for with monopoly ratepayer funds.

Moreover, the FCC has granted AT&T substantial regulatory relief in the past few years: private line tariffs can be justified on a standard other than fully distributed costs; MTS reductions can be justified under a net revenue test; and a fully separated subsidiary is no longer required for AT&T's unregulated equipment business. This releif has been granted even though, according to its own treasurer, AT&T retains an 80 percent share of the market.

In conclusion, price are not the magic solution to all of our problems in telecommunicatons. The Commission should not be allowed to substitute mechanistic formulas for the kind of oversight that is needed over monopoly local exchange carriers—and it should not be allowed to walk away from those competitive problems that remain to be solved in the interchange market.

Price caps for the local exchange carriers will harm consumers and competition. Price caps for AT&T do not address the real issues in the industry today.

Thank you.

Senator INOUYE. Thank you, Mr. Kovach.

And now the President of Southern Bell, Mr. Skinner.

STATEMENT OF FRANK SKINNER, PRESIDENT, SOUTHERN BELL

Mr. SKINNER. Thank you, Mr. Chairman.

My name is Frank Skinner, and I am President of Southern Bell, testifying today on behalf of the Bell South Corporation.

I appreciate very much the opportunity to appear before you to discuss the Federal Communication Commission's price cap proposal.

More than that, we are deeply grateful for your continuing interest in this vital issue.

Two dominant forces characterize the communications industry today. The evolutionary introduction of new products and services that typified our past has given way to a worldwide revolution in technology. That technology is no longer spawned in one laboratory, nor in one country, nor in one scientific discipline.

There is already an extraordinary competition among vendors and between nations that grows and grows with every passing day.

These two strong forces—revolutionary technology and competition in communications—are changing our society. They impact our economy at home and abroad. They affect the way we live, the way we work, the way we play.

They will, if given the proper chance, remarkably benefit human relationships for generations to come. But we must manage the transition from our past into our Information Age future.

Strict rate of return regulation has served that past. Conversely, it will only disserve the future by inhibiting some of the most capable corporations in our nation from doing what they best can do.

Under current rate of return regulation, a ceiling is placed on the earnings of telephone companies, and this indirectly regulates the prices of services.

Under the alternate form of regulation, known as price caps, ceilings are instead placed directly on prices.

The FCC's proposal to adopt price cap regulation for interstate services offers an opportunity for both consumers and investors to benefit in a number of important ways.

Immediately, consumers will enjoy lower prices than they otherwise would, and, on the longer-term basis, benefit indirectly from increased efficiency and innovation.

Universal service will be strengthened in the process.

Under price caps, companies are encouraged to invest in innovative new technologies, to achieve cost efficiencies, and establish competitive prices for quality services that meet customer needs. These incentives will be present because of the increased opportunity to improve earnings.

Investors who today have a multitude of choices for investing in communications and will inevitably place their dollars where the returns are the highest will be encouraged to supply the large investments that local exchange carriers require to serve their mass markets.

Individuals desiring careers in telecommunications are also competitively sought after today and can be expected to apply their skills where the opportunities are greatest. They are more likely to be attracted toward careers in the carrier industry under a form of incentive regulation.

Small companies and large companies both will be the beneficiaries. But, again, consumers are the ultimate beneficiaries, gaining from the resulting new service offerings and lower costs that come from productivity improvements instituted by the companies.

Price caps are a continuing form of regulation. The FCC proposal for directly regulating prices includes an annual adjustment formula with a consumer productivity dividend, which insures that inflation-adjusted prices will be lower than those produced historically.

It includes strong incentives for high quality service, which we are unequivocally committed to. At the same time, pricing flexibility will enable carriers to compete by reacting more quickly to marketplace demands. Costly regulatory red tape is reduced.

Price caps present one of those rare opportunities when everyone can win.

The customer is guaranteed to be better off. Shareholders have no guarantees, but their risks are more closely matched with incen-

tives. And the country is better positioned to stay at the forefront in the development of information services for the future.

State regulators are already instituting a variety of new plans to put more flexibility and incentives in regulation and make it more adaptable to the new Information Age. More than 20 States are in some stage of regulatory change.

In my own company, Florida is considering a Southern Bell petition for incentive regulation, and both Georgia and South Carolina have passed legislation to permit detariffing of selected services.

We believe that price cap regulation is a distinct improvement over traditional rate of return regulation. But that really does not say it all. The fact is rate of return regulation, the status quo, is no longer appropriate for the competitive Information Age. New opportunities require new insights and actions.

We applaud Congress for its interest, its concern and its attention. But we urge you to give the FCC proposal a chance.

Change is needed. This change holds promise and is certainly in the right direction to benefit all the stakeholders in our industry.

Thank you.

Senator INOUYE. Thank you very much, Mr. Skinner.

Now may I call on the First Vice President of the United States Telephone Association, Mr. Hasselwander.

STATEMENT OF ALAN C. HASSELWANDER, FIRST VICE-CHAIRMAN, U.S. TELEPHONE ASSOCIATION AND PRESIDENT, ROCHESTER TELEPHONE CORP.

Mr. HASSELWANDER. Thank you, Mr. Chairman.

I am Alan Hassselwander, President of Rochester Telephone Corporation. I am appearing before you today on behalf of the United States Telephone Association, of which I serve this year as First Vice Chairman.

USTA, as you know, is the principal trade association of the local exchange carrier industry. Its membership of approximately 1,100 local telephone companies, provides 99 percent of the local exchange carrier-provided access lines in the United States.

USTA has provided the Subcommittee with copies of its written statement, and I would like quickly to summarize that statement.

The pending FCC proceeding is of critical importance to the local exchange carrier industry. It proposes an alternative form of regulation that allows local telephone companies to respond to changes in the telecommunications marketplace more efficiently than under the current rate of return regulation.

It is essential for many companies to implement price cap regulation as soon as possible. Price cap regulation can control prices to consumers, while providing incentives for carriers to innovate. Any delay in implementing price cap regulation merely postpones those opportunities.

USTA supports the application of price cap regulation on a voluntary basis to the interstate access services provided by local exchange carriers. Price cap regulation will lessen the costs of regulation itself. It will shield customers from abrupt rate increases, yet pass through a "dividend" based on anticipated productivity improvements.

Price cap regulation encourages a competitive, market-based response to costs and to ever-advancing technology. It increases the incentive for telephone companies to serve their markets better and offer new services to meet customer demand.

Questions have been raised about the price cap form of regulation today. To answer those questions, it is important to note what this form of regulation is not.

Price cap regulation is not deregulation. It will not diminish the Commission's responsibility under the Communications Act to ensure reasonable rates. It will not eliminate or reduce State commission jurisdictional authority over intrastate services. It will not affect current procedures to separate interstate and intrastate costs.

The price cap proposal affects only interstate revenues—less than a quarter of the telephone revenues received by our companies. It will not create opportunities to cross-subsidize. There is no incentive to purposefully lose money in one market, because the cap will prevent overpricing interstate access, while intrastate revenues are under the jurisdiction of State regulators.

It will not cause carriers to reduce service quality. Cost control and service are complementary and not contradictory. For example, investments in digital technology improve service while reducing costs. Streamlining procedures and practices improve service and reduces costs. And excellent service is a key to our success in successfully competing to provide access services to our largest customers.

There have been concerns raised about the effect of price caps on small telephone companies and rural customers. We, too, are concerned that the Commission's plan does not specifically address all of the small company issues, and we covered these points in our filing.

Small company issues include the following:

Continued nationwide uniform toll rates—we agree;

Continued long-term support of the pooling process—we agree;

Continued use of an industry-wide rate of return—we agree;

Elimination of the productivity offset for small companies—we agree.

Our industry is in full support of these issues, and we are confident that they will be appropriately addressed by the FCC in future orders.

USTA is pleased that the Commission's proposed price cap plan offers local exchange carriers the same opportunity as AT&T to elect price cap regulation. Since local exchange carriers and long distance companies offer high volume and many other services in competition with one another, this is an effective way to help maintain incentives for continued use of our basic networks by large businesses and others, and to insure that the prices paid by customers reflect the cost benefits which are possible under price cap regulation.

Growing competition for telecommunications services necessitates a change in the way local exchange carriers are regulated. Therefore, this industry is encouraged by efforts to develop a constructive form of price cap regulation.

We view price caps as a long-term proposal for more efficient regulation, and not a short-term opportunity to improve earnings. Price cap regulation can provide a unique opportunity for a win-win situation, improving the lot of both consumers and the industry.

We will continue to work with you and the regulators to finalize a plan that accomplishes this objective.

The United States has the best telephone service of any nation in the world. I believe a change in regulation is needed to keep it that way.

That concludes my prepared statement.

Thank you.

[The statement follows:]

STATEMENT OF ALAN C. HASSELWANDER, PRESIDENT, ROCHESTER TELEPHONE CORP. ON BEHALF OF U.S. TELEPHONE ASSOCIATION

USTA supports the Application of price cap regulation for interstate access services, on a voluntary basis, to local exchange carriers.

Price cap regulation can address the major deficiencies of the current rate of return process by lessening the cost of regulation, protecting customers from price increases and providing them with a guaranteed "dividend" based on a carrier's productivity, and building better incentives into the regulatory process to increase efficiency and encourage innovation.

Price cap regulation is not deregulation. It will not diminish current statutory obligations or procedures to ensure reasonable rates and high quality service.

Current service quality monitoring, at the federal and state level, which includes various technical and engineering reports as well as detailed complaint procedures will ensure that isolated problems and overall service quality are tracked and will provide a sufficient means for the Commission to monitor and document service quality changes under price cap regulation.

Price cap regulation will not reduce state commission jurisdictional authority over intrastate services. The separations manual, developed by a Federal-State Joint Board, will not be affected by implementation of price cap regulation. A new automated repooling system will monitor jurisdictional costs.

Local exchange carriers not electing price cap regulation must receive regulatoy relief from the current burdensome rate of return process and the Commission should proceed expeditiously to provide the needed regulatory reform.

The Commission's plan provides the same incentives as the USTA price cap plan, but should be modified as follows:

(1) Smaller and mid-size carriers must have the opportunity to achieve the benefits possible under price cap regulation, therefore the voluntary nature of the plan will facilitate the needs of these carriers to fully and carefully assess their unique circumstances and should be continued beyond the initial price cap period.

(2) Smaller and mid-size local exchange carriers must have a lower productivity offset in order to benefit from price cap regulation. Productivity studies confirm that there are differences in rates of productivity growth between smaller and larger telephone companies due to the fact that smaller carriers do not have the same economies of scale and scope as larger carriers. Even for longer carriers, the productivity factor of 2.5 percent is inappropriate since it is based on outdated studies which do not reflect the current industry structure.

(3) A second price cap election date for carriers remaining in the NECA pool must be adopted since the current election date will preclude some carriers from the opportunity to implement price cap regulation.

(4) Depooling carrier should be permitted to implement price cap regulation immediately in order to relieve a potential administrative burden.

(5) Small and mid-size carriers must not be required to elect price cap regulation on an "all or nothing basis" which would preclude affiliated companies with geographically and economically diverse areas from electing price cap regulation.

(6) Qualified smaller carriers should be permitted to utilize streamlined regulatory procedures whenever feasible under price cap regulation particularly in filing above-cap tariffs.

(7) Average schedule companies should be allowed to implement price cap regulation so that their customers, too, can benefit from this form of regulation.

(8) The total common line revenue requirement should be included in the initial price cap filing to ensure that all common line rate elements are incorporated in the price cap formula in a consistent manner and to remove any uncertainty as to how common line rates will be calculated. The demand response, resulting from exogenous changes in carrier common line rates, which would be treated as an exogensous cost change, under the Commission plan should include only the demand stimulation directly attributable to specific, exogenous cost changes.

(9) Two baskets and an extremely limited pricing band as proposed by the Commission, the unnecessary and may preclude even limited pricing flexibility necessary to meet changes in costs and market conditions. In addition, the "no credit rule" may penalize carriers for seeking to lower prices.

(10) The development of initial rates if flawed, as it proposes to average two diverse costs structures and may cause initial rates to be different than existing rates. A nine month base rate using existing rates will meet the Commission's objectives.

(11) The price cap formula should be calculated using the first revision of the GNP-PI in order to allow companies more time to prepare their filings and using the annual rates of change in inflation and productivity.

(12) Other items, including equal access cost recovery, interexchange carrier migration, pool support obligations and GAAP changes, should be considered as an exogenous cost change since they meet the Commission's definition.

If modified as suggested herein, the Commission's price cap plan can provide lower prices to a broader range of customers and more efficient regulatory incentives to a larger number of carriers.

Senator INOUYE. I thank you very much, Mr. Hasselwander.

As many of you must have noted, that buzzer indicates that there is a vote in process in the Senate. So, if I may, I would like to call a recess for ten minutes.

[Brief recess.]

Senator INOUYE. I will call as our next witness the General Manager of the Grand River Mutual Telephone Corporation, Mr. Robert McArton.

STATEMENT OF ROBERT A. McARTON, GENERAL MANAGER, GRAND RIVER MUTUAL TELEPHONE CORP. ON BEHALF OF THE NATIONAL TELEPHONE COOPERATIVE ASSOCIATION

Mr. MCARTON. Thank you, Mr. Chairman.

It is a pleasure to be with you, and I appreciate the opportunity to discuss small company concerns about price caps.

My name is Robert McArton, and I am the General Manager of Grand River Mutual Telephone Corporation in Princeton, Missouri.

Today I am representing the National Telephone Cooperative Association.

NTCA has participated in the price cap proceeding at the Commission since its inception. We testified before the House Telecommunications Subcommittee last November about small company concerns. At that time, FCC Chairman Dennis Patrick assured the Subcommittee that small company issues would be addressed in its further proceedings.

Commissioners Fowler and Patrick have also assured Members of the House and Senate that the Commission would comply with the Regulatory Flexibility Act and analyze the impact of their decisions on small companies before regulations are issued.

However, in May, the Commission released its further notice, and still small company concerns were not adequately resolved.

We are very concerned that replacing rate of return regulation with price cap regulation will adversely affect the small company protective mechanisms established under the Unity 1-A Agreement.

The Unity 1-A Agreement, which was developed by all of the associations representing the local exchange industry, was adopted by the Commission with only minor modifications. This agreement has become the industry blueprint for interstate access charge regulation, and includes important provisions in the access charge structure and addresses two fundamental small company concerns.

The first is serving rural areas involves higher costs. Small telcos require allocation and recovery methods, which insure that local basic rates, carrier access charges, and subscriber line charges remain at reasonable levels.

Secondly, rural subscribers need continued support for nationwide, geographically averaged toll rates.

The current access charge plan accommodates these concerns by providing pooling options for small telcos and a universal service fund, which helps small telcos recover costs, so they won't be forced to charge unreasonably high service rates.

Although the pooling process was modified to let telephone companies leave the pool, this important, long-term support mechanism was kept in place. It is designed to minimize the disparity in access charges between those who leave the pool and those who stay in.

Limiting the price differences among the various telcos in the country is key to the effort to minimize pressures on AT&T to deaverage long distance rates

Mechanics for the execution of these safeguards are currently in the Commission rules, as was stated this morning, but are not addressed in the price cap proposal, and we feel must be.

Let me explain.

In its further notice, the Commission has proposed to exempt carriers electing price caps from certain requirements of Part 65 of its rules. However, Part 65 spells out the procedures the Commission uses to determine the industry-wide rate of return and the kind of information telcos must file so the Commission can do so.

The National Exchange Carriers Association, the entity in charge of administering the Universal Service Fund and the pools, then uses the industry-wide rate of return to calculate small company support.

Unless an industry-wide rate of return is used in these calculations, wide rate distortions are likely to occur, which would increase pressure to deaverage toll rates and bypass the local switch network.

Rate distortions could also result in too much or too little universal service fund support. Without these small company safeguards, prices to rural subscribers could rise dramatically.

Secondly, NTCA believes that price cap regulation is not appropriate for all telephone companies and should not be made mandatory. Small sized and sparcely populated service areas make the price cap approach inappropriate for a vast majority of the small companies in our association.

In addition, small telcos are already running very efficient operations, and would have difficulty increasing productivity by trimming the fat.

Mr. Chairman, if the FCC moves forward with price cap regulation, we urge Congress to require that it include in any final order

the small company protection mechanisms included in the Unity 1-A Agreement and in current regulation. Small companies and their subscribers have too much at risk to rely on verbal assurances that their concerns will be addressed.

Thank you.

[The statement and questions and answers follow:]

STATEMENT OF ROBERT A. MCARTON ON BEHALF OF THE NATIONAL TELEPHONE COOPERATIVE ASSOCIATION

INTRODUCTION

Good morning Mr. Chairman and members of the subcommittee. My name is Robert A. McArton and I am General Manager of Grand River Mutual Telephone Corporation, in Princeton, Missouri. I am also a a Subset III Director of the National Exchange Carrier Association and a Director of the Missouri Telephone Association.

Today, I represent the National Telephone Cooperative Association (NTCA), a national trade association made up of 470 locally owned and operated small, rural, independent telephone systems located in over 40 states. Despite written and verbal assurances to the Congress and to industry officials, the FCC still has not adequately resolved small company questions and concerns in its proposed price cap regulation. Therefore, NTCA believes legislation is needed to require it to do so.

BACKGROUND

In 1986, the FCC conducted a scheduled review of its interstate access charge plan. NTCA and other telephone associations—United States Telephone Association (USTA), Organization for the Protection and Advancement of Small Telephone Companies (OPASTCO), and National Rural Telephone Association (NRTA)—after intensive discussions, developed a package of amendments to the plan which could be endorsed by large and small telcos alike and could be presented to the FCC during its deliberations. This effort resulted in the "Unity 1-A Agreement," a carefully-balanced set of issue resolutions forming a compromise plan. In April 1987, the Commission adopted the industry proposal with only minor modifications. Accordingly, the Unity 1-A Agreement is the industry blueprint for interstate access charge regulation.

The agreement includes provisions to preserve important small company safeguards in the access charge structure. Small telcos and their subscribers benefit under the plan in the following ways:

Additional Universal Service Fund (USF) support is targeted to small, high-cost telephone systems;

An overall, industry rate of return is maintained to properly protect rural, high-cost, highly leveraged telecos; and

The pooling and recovery of non-traffic sensitive loop costs are modified in such a way that pressures threatening contained nationwide toll rate averaging are minimized.

Larger companies benefit through reduced mandatory pooling of costs, giving them greater pricing flexibility and through an increase in subscriber line charges from $2.00 to $3.50.

In August 1987, only four months after adopting the Unity 1-A Agreement as regulation, the Commission proposed to replace rate-of-return regulation with price-cap regulation. The price-cap proposal does not adequately address the small company safeguards agreed to by the industry in the Unity 1-A compromise. The Commission mentioned small company concerns, such as geographic rate averaging and pooling, in its Notice of Proposed Rulemaking, but did not proceed to describe how these provisions would be maintained under the price cap proposal. Provisions benefiting large companies remain basically intact.

On November 10, 1987, NTCA appeared before the House Telecommunications and Finance Subcommittee to express our concerns about the effect of price caps on the carrier common line pool and toll rate averaging. If these concerns were not statisfactorily addressed in the price cap rules, rates to rural subscribers could rise dramatically. FCC Chairman Patrick also testified that day, and assured the subcommittee that small company concerns would be addressed in the Further Notice of Proposed Rulemaking. However, in May 1988, the Commission released its Further Notice, which included specific recommendations and proposed rules, but did

not adequately provide for the maintenance of small company safeguards contained in current regulations.

On July 12, 1988, Representative Jim Cooper (D-TN) introduced H.R. 5019, which requires the FCC to include these safeguards before price caps can take effect.

THE PRICE CAP PROPOSAL MUST BE MODIFIED TO ENSURE CONTINUATION OF THE UNIVERSAL SERVICE PROVISIONS ESTABLISHED UNDER THE UNITY 1-A AGREEMENT

The benefits small companies receive under the Unity 1-A Agreement and current FCC regulation are designed to preserve universal service by keeping rates affordable to rural subscribers. The Unity 1-A Agreement includes important provisions in the access charge structure which address two fundamental small company concerns: First, because serving rural areas involves higher costs, small telcos require cost allocation and recovery methods which insure that local basic rates, carrier access charges and subscriber line charges remain at reasonable levels. Second, rural subscribers need continued support for nationwide, geographically-averaged toll rates.

The current access charge plan accommodates these concerns by providing pooling options for small telecos. Pooling benefits them by providing for price averaging along with cost, risk and resource sharing among participants. Second, the Universal Service Fund was retargeted to small high cost systems to aid in cost recovery so that they would not be forced to charge unreasonably high local service rates.

Although the common line pooling process has been modified to allow telephone companies to leave the pool, the important long term support mechanism was put in place. It is designed to minimize the disparity in access charges between those who leave the pool and those who stay in. The intent of the long term support mechanism is to limit the carrier common line rate charged by the pool participants to the level the rate would have been if mandatory pooling had been maintained. Limiting price differences among the telephone systems throughout the country is integral to the effort to minimize pressures on AT&T to geographically deaverage long distance rates. Mechanics for execution of these safeguards are contained in Parts 36, 65 and 69 of the Commission's rules, and depend on the maintenance of an overall industry rate of return. These mechanisms have not been satisfactorily addressed in the proposed price cap regulations.

In its Further Notice, the Commission has proposed to exempt carriers electing price caps from certain requirements of Part 65 of its rules. However, Part 65 rules spell out the procedures the Commission uses to determine the industry-wide rate-of-return and the kind of information telcos must file so the Commission can do so. The National Exchange Carrier Association (NECA), the entity in charge of administering the Universal Service Fund and the pools, then uses the industry-wide rate of return to calculate small company support. The industry average rate-of-return is used to determine the nationwide average loop cost, upon which Universal Service Fund assistance is based, to develop a nationwide carrier common line rate, to determine long term pool support, and finally, to develop rates for those companies who decide to remain under rate-of-return regulation. Unless an industry-wide rate of return is used in these calculations, wide rate distortions are likely to occur. Rate distortions could also result in too much or not enough Universal Service Fund support for small telcos.

An industry-wide rate of return is needed in order to calculate the carrier common line rate and long term support as well. Otherwise distortions would occur and the resulting widely-varying rates would exacerbate pressure to deaverage toll rates and bypass the local switched network.

Therefore, the Commission needs to ensure that these safeguards, even though they are already included in the FCC's rules, are not jeopardized by the implementation of a price cap regime. It must retain adequate authority to gather the necessary data in order to ensure the proper workings of the small company protection mechanisms it adopted as a result of the Unity 1-A Agreement. It should also more firmly commit to its stated policy on rate averaging and adopt specific rules in its price cap proceeding which require dominant carriers to charge geographically averaged long distance rates. Price cap rules should be consistent, not conflict, with existing rules.

PRICE CAP REGULATION IS NOT APPROPRIATE FOR ALL TELEPHONE COMPANIES AND SHOULD NOT BE MADE MANDATORY

In the Further Notice, the Commission states it plans to conduct a comprehensive performance review after three years of price cap regulation" and then decide whether price caps should apply to all dominant carriers.[1]

The basic principles and incentives underlying the price cap scheme are not realistic for most small companies. Small size, sparsely populated service areas and challenging universal service goals severely undermine the benefits of a price cap approach for small, rural telcos and their subscribers. For any benefits to accrue, carriers must believe they can achieve advances in productivity which at least meet mandated target gains. Such a commitment would be risky to small companies, because external factors could make it impossible to maintain the prescribed productivity increases, with the result that they would not fully recover their costs of operation. In addition, small telcos are running very efficient operations and will have difficulty increasing productivity by trimming "the fat."

The inescapable conclusion is that the price cap plan is not for everybody, and the Commission itself agrees. Nevertheless, the Commission also holds over the head of small companies, the spectre of mandatory participation in price caps after the study period. This option should be rejected out of hand today.

A COMPLETE REGULATORY FLEXIBILITY ACT ANALYSIS SHOULD HAVE BEEN PERFORMED BY THE COMMISSION

NTCA is concerned about the lack of an impact analysis on small companies, especially in a rulemaking such as price caps. In the original Notice of Proposed Rulemaking, the Commission stated a Regulatory Flexibility Analysis[2] of the impact of this proposed rule change was not required because price caps would not have a significant impact on a substantial number of small entities.[3] To the contrary, the price cap proposal will have a major effect on small telcos. In fact, the magnitude of its effect on the whole industry is undebatable. We also disagree with the Commission's assertion that small, rural telephone systems are "dominant"[4] for the purposes of the Act and therefore not eligible for an analysis.

The Commission, in the *Further Notice,* continued to claim the Regulatory Flexibility Act was not applicable to the price cap proceeding,[5] but claimed to analyze price caps' impact on small companies anyway. That analysis is only one paragraph long and is totally deficient in terms of compliance with the procedures contained in the Act.

Congress has expressed a desire to see the Regulatory Flexibility Act applied to small telephone systems as well. In a letter[6] to Congressman Ike Skelton, former FCC chairman Mark Fowler, agreed to accede to Congress' will and analyze the impact of its rulemakings on small telephone companies. Fiscal Year 1987 appropriations committee report language request the FCC to perform this analysis.[7] Chairman Patrick, in a letter to Senator Dale Bumpers[8] assured him that the impact of price caps on small companies would be thoroughly examined.

No impact analysis on small companies has been done, however, in spite of congressional instructions and FCC promises to the contrary. If the Commission had performed the Regulatory Flexibility Act analysis, the whole debate over small company safeguards being adequately addressed may not have arisen.

CONCLUSION

NTCA has participated in the price cap proceeding since its inception. We appeared before the House Telecommunications and Finance Subcommittee in Novem-

---

[1] *In the Matter of Policy and Rules Concerning Rates for Dominant Carriers,* Further Notice of Proposed Rulemaking, CC Docket No. 87-313, released May 23, 1988, ¶ 176.

[2] 5 U.S.C. § 601

[3] *In the Matter of Policy and Rules Concerning Rates for Dominant Carriers,* Notice of Proposed Rulemaking, CC Docket No. 87-313, released August 21, 1987, ¶ 78.

[4] 13 C.F.R. § 121 3(c)

[5] *Further Notice,* ¶ 517.

[6] Letter to Rep. Ike Skelton from Federal Communications Commission Chairman Mark S. Fowler, December 22, 1986.

[7] Senate Report No. 99-425, 99th Cong., 2nd Sess., accompanying H.R. 5161, as reported from the Senate Appropriations Committee, September 3, 1986, p. 71 and House Report No. 99-669, 99th Cong., 2d Sess., accompanying H.R. 5161, p. 61.

[8] Letter to Senator Dale Bumpers from Federal Communications Commission Chairman Dennis R. Patrick, March 16, 1988.

ber and at that time stated our neutrality on price caps as long as small company concerns were addresses. It is almost a year later, and still the commission has not adequately resolved these issues.

We are profoundly concerned that the replacement of rate-of-return regulation with price-cap regulation will adversely affect the protective mechanisms for small companies established under the Unity 1-A agreement. Therefore, we would actively support legislation which would require the FCC to include small company safeguards in any further proceedings to change the method of regulating interstate telephone service.

NTCA urges Congress to ensure the Commission include mechanics in its price cap rules to protect Unity 1-A safeguards, ensure the continuation of toll rate averaging, and to make perfectly clear that price caps shall remain voluntary.

QUESTIONS OF SENATOR PRESSLER AND THE ANSWERS

Question. Has the FCC satisfactorily addressed the concerns of the small telephone companies?

Answer. No. Despite repeated verbal and written assurances, the FCC has not satisfactorily addressed the concerns of the small telephone companies. The price cap plan, as outlined in the Further Notice of Proposed Rulemaking does not adequately address the small company safeguards agreed to by the industry in the Unity 1-A compromise. The Further Notice also does not guarantee that price cap regulation will be optional.

Question. Chairman Patrick has said that current small company safeguards are not affected by the price cap proposal. Do you agree?

Answer. NTCA does not agree with Chairman Patrick that small company safeguards are not affected by the price cap proposal. Mechanics for the implementation of small company safeguards are contained in Parts 36, 65 and 69 of the Commission's rules. Of critical importance is the long term support mechanism which is designed to minimize access price differences and thereby minimize pressures on long distance carriers to geographically deaverage toll rates. This mechanism was designed to function in a cost-of-service regulated industry. Since under price cap regulations carriers will be able to charge prices in ways that are not directly tied to underlying costs, the long term support mechanism may be undermined if rule changes are not adopted to accommodate this change in foundation.

Second, the Further Notice proposes to modify the Part 65 rules regarding Rate of Return to eliminate the existing industry wide rate of return and the mechanism for modifying it. Chairman Patrick's testimony was that the Further Notice "does not intentionally disturb the Commission's practice of prescribing a unitary rate of return for local exchange carriers" (emphasis added). Intentional or not, the proposed changes would make it impossible to compute the Universal Service Fund, NECA common line rate, and the long term support amounts. We understand the Commission intends to correct this apparent oversight, but that commitment should be made explicit.

Question. How much would local rates rise if the Unity 1-A safeguards did not stay in place?

Answer. It is difficult to give a precise figure for the rise in local rates if Unity 1-A safeguards were displaced. The interrelationships are very complex and any estimation would necessarily be based upon multiple assumptions. However, many small carriers receive a substantial percentage of their revenue from the interstate pools administered by the National Exchange Carrier Association (NECA). For example, my cooperative receives approximately 47% of its total revenue from the interstate pools. My colleague, Jimmy White of EIT Rural Telephone Cooperative, told the House Telecommunications and Finance Subcommittee that his cooperative receives 36% of its revenue from the pools. If interstate revenues drop, the decrease would have to be compensated for elsewhere. Local rates would have to share the burden of this revenue shortfall through increases.

Question. Specifically, what are the small company safeguards you're concerned about?

Answer. The small company safeguards are the universal service mechanisms included in the Unity 1-A Agreement which are designed to preserve universal service by keeping rates affordable to rural subscribers. Specifically, these mechanisms are the long term support for the NECA carrier common line (CCL) pool and the Universal Service Fund. NTCA is concerned that price cap regulation does not jeopardize the calculation of the carrier common line rate, the long term support to be provided by carriers leaving the CCL pool in April, 1989, and Universal Service

Fund support. The Commission must maintain an industry-wide rate-of-return so that these mechanisms will work properly.

The Unity 1-A agreement also supports a continuation of the FCC's policy on geographic toll rate averaging, which is recognized as a cornerstone of universal telephone service. Changes in the telecommunications industry, including the introduction of price caps, will inevitably lead to less uniformity in rates across the nation. Therefore, the Commission should commit firmly to its stated policy of nationwide, uniform toll rates by adopting specific rules in the price cap proceeding which require dominant carriers to maintain geographically averaged long-distance rates.

Question. Should small companies be required to meet the same productivity factor as the larger companies?

Answer. Because any nationwide cost or productivity factor is likely to be a mismatch for most small companies, small telcos are unlikely to be able to utilize price cap regulations. Rural telcos are already operating efficiently and pressure to meet an unattainable productivity factor could only result in degradation of service. It is therefore necessary that price-cap regulation continue to be voluntary even after a trial with large companies.

Senator INOUYE. Thank you very much, Mr. McArton.

Now may I call on the Public Counsel of the State of Florida, Mr. Jack Shreve.

Mr. Shreve.

STATEMENT OF JACK SHREVE, PUBLIC COUNSEL OF THE STATE OF FLORIDA, ON BEHALF OF THE NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES [NASUCA]

Mr. SHREVE. Thank you, Mr. Chairman.

My name is Jack Shreve, and I am the Public Counsel of the State of Florida and Chairman of the Telecommunications Committee for the National Association of State Utility Consumer Advocates, or NASUCA.

The National Association of State Utility Consumer Advocates is an organization of State officials from 38 States and the District of Columbia, charged by statute to represent the interests of customers before the State public utility commissions and Federal regulatory agencies, such as the FCC.

The National Association of State Utility Consumer Advocates is unconvinced that the price cap model of regulation will prove superior to the rate of return regulation in protecting and promoting the interests of customers and of society. We are concerned that it will, instead, reduce the protection now afforded to rate payers, making them worse off than they would be under the current form of regulation.

As Mr. Skinner, the President of Southern Bell pointed out, Florida is, at this time, considering a Bell proposal with a similar type arrangement. That is opposed by the Office of Public Counsel, representing all of the customers of the State, as well as all other intervenors, which are the Florida Retail Federation, the Federal Department of Defense, and many others, including other long distance carriers.

We feel that that plan is flawed, as is this plan that is being presented to you now. One of the primary reasons is that the money is already there for the revenues. The rates are already set at a level that will produce very, very high earnings, inordinate earnings. Without incentives and without additional efficiencies, without cutting rates to the proper level, the price cap is wrong to start, with the level of rates, that you have at this time.

We have several strong misgivings about the price cap approach that are not diminished by the FCC's latest plan. One is that the price cap method will actually increase, rather than lower, the administrative costs of regulation. Another is that the price cap system will substantially reduce the already limited opportunity for public participation in interstate regulatory proceedings, and that it will improperly reverse the burden of proof from dominant carriers to intervenors in such proceedings.

NATSUCA urges this Committee to reject this wholesale change in the existing regulatory system, and, instead, to encourage the FCC to pursue methods of improving regulation within that system. Such an approach would be far less risky, and could be implemented and tested in a gradual manner, without the turmoil that could be created by an entirely new system.

The FCC could begin by thoroughly investigating the various regulatory innovations that have been introduced into the rate of return models by various State commissions. This is a proper course of responsibility, responsible regulatory reform.

Thank you very much, Mr. Chairman.

[The statement follows:]

STATEMENT OF JACK SHREVE, PUBLIC COUNSEL OF THE STATE OF FLORIDA ON BEHALF OF THE NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES [NASUCA]

Mr. Chairman and members of the committee, my name is Jack Shreve. I am the public counsel of the State of Florida and chairman of the Telecommunications Committee for the National Association of State Utility Consumer Advocates [NASUCA]. NASUCA is an organization with representatives from 38 States and the District of Columbia charged by statute to represent the interests of customers before State public utility commissions and Federal Regulatory Agencies such as the FCC.

I appreciate the opportunity to offer my testimony to the committee, as you evaluate the supplemental "price cap" proposal that was recently set forth by the Federal Communications Commission.

NASUCA opposes this fundamental and drastic change in the current system of regulation. We believe its implementation would enrich dominant telecommunications carriers like the local exchange companies and AT&T at the expense of their customers, many of whom—particularly residential and small business subscribers—would pay more to get less.

These remarks have a four-part organization: First, a defense of our current system of regulation; second, a critique of the price-cap concept; third, a critique of the FCC's latest price cap proposals; and fourth, a conclusion.

The FCC has jumped on the bandwagon with those who are attacking rate-of-return regulation as out of phase with the whole movement to cost-based pricing. It is a quaint anachronism, they say, the burdensome legacy of a creed outworn. Its cost-plus foundation creates perverse incentives for rate-base padding, discourages innovation, and runs up administrative costs. Away with it!

Strong words, but where is the evidence? Neither the FCC nor any other proponent of the price cap approach has demonstrated that rate of return regulation is factually culpable on any of these counts, or that any tested alternative, here or abroad, can regulate the telecommunications industry any more effectively, or indeed as well. All that has been offered is theoretical speculation and anecdotal reminiscence.

Furthermore, telephone customers and the telephone system in general have fared extremely well under rate-of-return regulation, which has fostered the best telecommunications system in the world.

How has this been achieved? By requiring carriers to emphasize service availability and quality, rather than high profits, and by keeping local rates so low that just about everyone has a telephone and can afford to use it. Under this supposedly onerous regulatory regimen, as the FCC itself has attested, our telecommunications industry has achieved significantly higher productivity increases than the U.S. econo-

my as a whole. How ironic for the FCC to now argue that rate-of-return regulation creates disincentives for efficiency and innovation!

Another alleged defect of rate-of-return regulation is that it prevents the regulated carriers from responding freely to competition and creates pricing distortions. Presumably, price capping would avoid these problems.

But the interstate toll and local access markets are by no means truly competitive. AT&T remains the dominant carrier—and as such, the price leader—in the interstate toll market. Unfettered, it can set prices, undercut its rivals, and reap monopoly profits. Local access services are almost totally monopolized, and the local exchange companies would love to have the freedom to take advantage of that fact.

If the rate-of-return approach needs modification, its flaws must first be carefully and convincingly documented, so that reasonable alternatives can be explored with everyone fully aware of what is to be corrected, or abandoned, or supplemented. In this direction lies responsible reform.

If fundamental change turns out to be needed (which I very seriously doubt), price-capping is a possible alternative. But not before several fundamental problems with it are solved.

First, the price cap system is supposed to be cheaper than rate-of-return regulation because it is supposed to be easier to administer. There is no proof of this; in fact, the contrary may well be true.

One reason for the high cost is that price caps will be offered as an option to carriers (thus letting them chose the regulatory scheme that they think favors them). The Commission will have to maintain and administer two separate regulatory systems. It defies logic to assert that this will result in lower overall costs.

The alternative would be for the FCC to switch cold-turkey to a price-cap system—to burn their regulatory bridges behind them. But as FCC Commissioner Dennis recognized in her "separate statement" regarding the FCC proposal, "even if all carriers opted for price caps, the Commission would maintain many of the reporting aspects of rate-base regulation to compile information on their earnings." There would not be any big savings on monitoring earnings; to the contrary, there would be big expenses setting up the price-cap administration.

A second major defect of the price cap approach is that it would significantly reduce the already-limited role of the public and its advocates in interstate regulatory proceedings and investigations. Review of price adjustments would be difficult, and effective protest almost impossible. So would any attempt to challenge the earnings of a dominant carrier.

Third, the Commission has naively assumed that under a price-cap system carriers would earn extraordinary profits only through extraordinary productivity. That's one way to do it. But there's another way, equally plausible: To cut costs by lowering the quality of service while maintaining price levels. This effectively transfers revenues from defrayal of operating costs to enlargement of profits. If the price-cap system were adopted, the burden would be on intervenors to prove that any excessive profits—if they can even be discovered—are the result of cuts in service quality, rather than true increases in the efficiency of production.

In contrast, the rate-of-return approach has always promoted service quality by allowing carriers to earn a reasonable return on any prudently incurred investment. And that system has worked.

Aside from those general defects, the Commission's latest proposal exhibits a number of specific flaws.

First, it accepts the existing rate levels as the starting point for price caps, without certifying their reasonableness, even in the aggregate. The Commission seems to think that the starting point is of transient interest only; we think it is of critical importance. It establishes the base level of the price cap index and the actual price index, both of which will influence the level of permissible rates far into the future. If this starting point is set too high—because either an unreasonble level of profits or an inefficient level of costs is built into the existing rate levels—then the price cap levels will remain inflated indefinitely.

For several reasons, the rate base and expenses of AT&T and the LECs have not had to withstand the thorough scrutiny by affected ratepayers and others that is a routine and critical part of rate case investigations at the State level.

At the interstate level, parties have been able to comment only on specific tariff proposals of the dominant carriers; they have not been able to monitor the carriers' aggregate earnings and thereby explore the reasonableness of the existing price levels. Are they reasonable? We don't know, and neither does the FCC. It is foolhardy to use them as a basis for establishing price caps, which will in turn affect the future earnings of the dominant carriers, without a complete investigation.

Second, the Commission wants to include excess productivity gains as a separate factor in the annual adjustments to the price cap index. According to the FCC, this productivity adjustment will ensure that ratepayers share the benefits of the carriers' productivity increases and associated cost reductions. This level of the productivity adjustment is of critical importance to the implementation of price cap regulation, since it will substantially influence the level of prices that may be charged by the dominant carriers and, thus, the reasonableness of their overall profit levels. The FCC thinks 3 percent is the proper figure; we think that's too low. Considering the most recent information, we think a productivity factor of at least 5 percent would be needed to ensure the benefits promised by the FCC.

Much of the productivity that the dominant carriers may achieve under price cap regulation will be possible because of past research and development financed by ratepayers under rate-of-return regulation. Ratepayers, not stockholders, should reap the benefits of these productivity gains.

Third, as part of the price cap plan, the Commission proposes to allow dominant carriers to vary their rates within a band set around existing rate levels, with limited regulatory review. The Commission proposes a band of 5 percent above and 5 percent below the rate level existing for a service in a given year. Rate increases for decreases within this band would essentially be at the carrier's discretion and would be practically immune to challenge.

We oppose this plan. Assuming they can be achieved at all, the perceived advantages of price cap over rate-of-return regulation do not require the granting of additional pricing flexibility to dominant carriers. Neither efficiency incentives nor administrative cost savings, to the extent they are possible under the price cap system, require carriers to be given increased pricing flexibility.

The proposal clashes with the FCC's pledge to refrain from deregulation. Under it, the burden of proof for tariff changes within the proposed bands is shifted from the dominant carriers to other parties.

Moreover, the banding concept could permit individual rates to be increased by more than the nominal 5 percent figure. That's because the existing rates would first be adjusted by the percentage change in the price cap index. The resulting adjusted rate would determine the center of the 5 percent upward and lower band of flexibility. Thus, if the index increased by 3 percent in a given year, the band would extend from 2 percent below to 8 percent above the existing, unadjusted rate level. As a result, some consumers could be socked with an 8 percent increase, even though the net increase experienced by the dominant carrier was just 3 percent. The evening and night discounts enjoyed mostly by residential customers could be knocked out in a number of years with the use of these bands.

The banding approach would also allow the dominant carriers to flow all cost reductions through to customers within their most competitive markets, while maintaining or increasing rates for their most captive customers. For instance, if the PCI declined by 3 percent in a given year, the carrier would reduce its most competitive rates by up to 8 percent, while it maintained or even increased its rates for services to the most captive customers.

Such results would belie the Commission's assurances to ratepayers that they "will share in the benefits of the greater efficiencies and innovations that we expect to result from price cap regulation." Some consumers would, others most surely would not. In AT&T's domain, we expect that residential and small business customers, who comprise the least competitive segment of that business, would get little if any benefit.

I will conclude briefly. NASUCA remains unconvinced that the price cap model of regulation will prove superior to rate-of-return regulation in protecting and promoting the interests of customers and of society. We are concerned that it will instead reduce the protection now afforded to ratepayers, making them worse off than they would be under the current form of regulation.

We hve several strong misgivings about the price cap approach that are not diminished by the FCC's latest plan. One is that the price cap method will actually increase, rather than lower, the administrative costs of regulation. Another is that the price cap system will substantially reduce the already limited opportunity for public participation in interstate regulatory proceedings, and that it will improperly reverse the burden of proof from dominant carriers to intervenors in such proceedings. The third is the perverse incentives that the price cap system will create for carriers to cut the quality of the Nation's telephone service in order to maximize their profit levels.

Therefore, NASUCA urges this committee to reject this wholesale change in the existing regulatory system, and instead to encourage the FCC to pursue methods of improving regulation within that system. Such an approach would be far less risky,

and could be implemented and tested in a gradual manner, without the turmoil that could be created by an entirely new system. The FCC could begin by thoroughly investigating the various regulatory innovations that have been introduced into the rate-of-return model by various State commissions. This is the proper course for responsible regulatory reform.

Senator INOUYE. Thank you, Mr. Shreve.

Next is Mr. Glynn, People's Counsel for the State of Maryland.

STATEMENT OF JOHN M. GLYNN, PEOPLE'S COUNSEL FOR THE STATE OF MARYLAND

Mr. GLYNN. Good afternoon.

My name is John M. Glynn. I currently serve as People's Counsel for the State of Maryland. The Office of People's Counsel is an independent agency of the State of Maryland, mandated to represent residential consumers of regulated utility services. We are also a member of NASUCA, as Mr. Shreve is, and we endorse his remarks and will not repeat them.

Rather, I will attempt to hit a few brief points which I think have been raised during the discussion here today, where I would like to add a few of my own comments.

First of all, I think the characterization by the FCC of rate of return regulation as cost-plus regulation is a misrepresentation.

I, like Commissioner Nelson of the Washington Commission, believe that the phrase "cost-plus" has a connotation which is unfair and unfortunate. Properly administered rate of return regulation does not guarantee earnings to any utility. It merely grants the opportunity to earn a fair rate of return if that utility is innovative and efficient.

Under proper rate of return regulation, rates are set at such a level so that these earnings can only reach the rate of return if the utility, in fact, behaves in an appropriate and efficient fashion. I think it is very troubling and unfortunate that the FCC feels that in order to entice and motivate utilities to be innovative and efficient, it is necessary to offer them the opportunity of super-normal profits. I do not think that is in the public interest.

AT&T has also argued in this proceeding that competition is an appropriate reason to do what the FCC has proposed to do. In fact, the FCC proposal is not based upon evidence of competition so rigorous as to restraint AT&T's earnings or their rates. If AT&T could make a case that competition could do this, there would be no reason for them to be regulated at all. In fact, they cannot make this case. Even the FCC concedes that they still possess substantial market power and need to be regulated in order to protect the public.

Competition is not an issue.

I also do not think the public should be enticed by substituting an offer of what is referred to as "stable rates" for what has traditionally been defined a "just and reasonable" rates.

The public would prefer low, unstable rates to high, stable rates. Under the current economic conditions in which this industry operates, we can anticipate substantially declining costs in the future. Under rate of return regulation, those declining costs which have occurred, as a result of innovations and efficiency which came

about under rate of return regulation—these would have resulted in substantially declining rates to the public.

It is not a question of increasing rates. It is not a question of stable rates. It is a question of the public being permitted to share in the declining costs which, under rate of return regulation, they would see pass through in rate reductions.

It is not a question of the industry being deprived of the opportunity to earn profits for innovation. It is a question of the industry being required to pass through to the public savings which already and inevitably will occur because of appropriate innovations which have already occurred.

In Maryland, the Maryland Commission has abandoned traditional profit regulation for AT&T of Maryland. We have seen declining rates for all customers. We have also seen profits for AT&T of Maryland varying over the last two years between 76 percent and 125 percent on rate base.

The public may be happy with declining rates, but these rates are not just and reasonable. Earnings such as this do not indicate that appropriate balances have been struck between consumers and the stockholders of the company.

Very briefly, on the issue for the potential for discriminatory rates, the FCC itself, in responding to Representative Markey's question on this issue, has indicated that in theory, it will be possible for AT&T to raise prices during evenings and weekends. As suggested in Representative Markey's question, "It is not obvious, the FCC says, that AT&T would take advantage of the banding limitation in this fashion."

Well, it may not be obvious; but it is quite likely. It is, in fact, what AT&T of Maryland has done with each filing which it has filed, reducing rates in the State of Maryland. They have reduced the relative level of discounts for evening and weekend calling, which is to the detriment of residential consumers.

I also would like to emphasize that the FCC proposal was hinged on the premise that utilities will respond to perverse incentives. I would suggest to you that there is a very substantial perverse incentive in this proposal, and that is for AT&T and other inter-exchange carriers to place less emphasis upon service, innovation and maintenance for those consumers, residential consumers, who have the least market power, as compared to larger business consumers and mid-sized business consumers.

This is a perverse incentive. The FCC believes the companies respond to these, and I suspect that this is what you will see—a potential problem in service quality.

I appreciate very much the opportunity to be here today. It is my belief and my suspicion that the FCC price cap proposal is a bad idea whose time has not yet come. I think further, rigorous analysis of rate of return regulation can come up with a much better proposal.

I thank you very much.

[The statement follows:]

STATEMENT OF JOHN M. GLYNN, PEOPLE'S COUNSEL, FOR THE STATE OF MARYLAND

My name is John M. Glynn, People's Counsel for the State of Maryland. The Office of People's Counsel is charged with representing the interest of residential

utility consumers, and is authorized to act at both Federal and State levels. This office has actively participated in the FCC price cap proceeding. Since Maryland is one of several states which has given AT&T the pricing flexibility similar to that proposed under the FCC's price cap proposal, I will focus my remarks on what can be learned from Maryland's experience with alternate forms of regulatory oversight.

The Federal Communications Commission has sought in its Further Notice of Proposed Rulemaking to repackage its price cap proposal to make it more acceptable to ratepayers. The proposed scheme, which is based upon the same assumptions and principles as the FCC's previous proposal, suffers from the same defects. In the name of efficiency and innovation, the Commission has opened the way for unlimited profitmaking for the carriers while providing incentives which could result in a deterioration in service quality.

While recognizing the massive staff effort required to produce the Commission's 227-page Further Notice, Maryland People's Counsel concludes that the document, like its predecessor, reflects beliefs and regulatory ideology more than facts and statutory intent. The regulatory scheme it proposes is elaborated in greater detail and phrased in terms calculated to appeal to consumer interests than previously, but it is no more protective of residential ratepayers now than when initially put forward.

People's Counsel also readily acknowledges that rate-of-return regulation is not perfect in all respects. It has, however, permitted the development of the world's most advanced and widely available basic service network. It has brought about dramatic reductions in rates for long distance service for many customers. Sensible public policy would aim at strengthening such a regulatory system at those points where it may be weak and adopting compatible incentive mechanisms to energize it in terms of innovation and efficiency. The Commission, unfortunately, proposes to abandon it in favor of a form of regulation whose benefits for the consuming public are speculative, at best, and whose enormous benefits for the providers of services are all too clear.

Cost-of-service regulation (also referred to as rate-of-return regulation) which sets a company's rates by regulating its profits provides a utility the opportunity to earn its cost-of-service and a fair rate-of-return. Cost-of-service regulation employed properly can discourage imprudent investment and wasteful expenditures while protecting the public from excessive rates. Under this regulatory system, the industry has invested in technology which promises to increase efficiency and lower costs in the future. This coupled with significant declines in costs due to tax law changes and cost shifting mandated by the FCC, as well as other increases in productivity and efficiency, gives telecommunication companies the potential of offering customers steadily declining prices.

Now, with declining costs justifying reduced prices to consumers, the FCC proposes to change the regulatory rules to allow the industry to keep the rewards of declining costs rather than share them with customers. Under the price cap proposal, dominant carrier earnings are not controlled. Price cap regulation is supposed to benefit consumers by stimulating the dominant carrier to operate more efficiently. While this idea is attractive to investors, the fallacy of this approach is that no competitive market exists to force dominant carriers like AT&T to lower prices to ratepayers to reflect cost saving. FCC orders, not competitive pressures, have forced AT&T to lower prices since divestiture. Only traditional rate-of-return regulation will assure customers that future cost declines will inure to their benefit. The experience in Maryland proves that under alternative forms of regulation like the price cap model, investors, not consumers, will reap the lion's share of the benefits associated with cost reductions. Indeed, in Maryland, while AT&T's rates have declined, its profits have soared.

The FCC relies heavily upon two assumptions in rejecting rate-of-return regulation. The Commission contends that rate-of-return regulation creates "perverse incentives" that encourage over investment and waste. The Commission also assumes that this proposal and the existence of emerging competition are sufficient to prevent excessive profits from being earned. The Maryland experience with AT&T indicates that the second assumption is baseless.

With respect to the first assumption, the FCC not only ignores the many years of beneficial experience with rate-of-return regulation, but apparently misunderstands the way rate-of-return regulation works. Rate-of-return regulation does not provide a guarantee of earnings or of cost recovery. It only provides an opportunity to earn. Under effective regulation, utilities have a substantial motivation to decrease costs and limit capital waste, in order to enable them to earn their authorized rate-of-return. So long as a company is failing to earn its authorized rate-of-return between rate cases, it has the opportunity to keep all of the additional profits it can generate

by efficiency. This fact, by itself, is a very substantial motivating force for efficiency. Likewise, regulation is designed to examine and eliminate inefficient expenditures and unnecessary capital improvements.

Moreover, if the FCC assumes that telecommunications companies respond to perverse incentives, it is reasonable to assume that the great bulk of rate reductions and the great bulk of capital improvements will be directed to those areas wherein there exists the most competition, that is, the large and middle-sized business user. This could result in service quality problems as well as discrimination against the smaller customer. It could be anticipated that, as in Maryland, most of the dominant carriers' rate reductions will be directed toward markets other than the residential market and most technological investment will be likewise directed away from the residential market. For instance, AT&T of Maryland's latest rate reductions in response to excessive earnings flowed mainly to such services as AT&T WATS, AT&T 800 Service, and AT&T MEGACOM rather than to MTS service.

Under price cap regulation, consumers are placed in the position of either relying on the generosity of AT&T's management to pass on cost declines to consumers or the ingenuity of the FCC in devising adjustment factors to secure these benefits for consumers. People's Counsel's experience with utilities in general, and AT&T of Maryland in particular, provides scant evidence that consumer welfare ranks high in the corporate hierarchy of values. Absent competition, AT&T can be expected to maximize profits to shareholders first and only provide price relief when profits become embarrassing.

The timing of the FCC's price cap proposal could hardly be better for investors or worse for ratepayers. Dominant carriers are entering a period of increased productivity resulting from past investment decisions. Since divestiture, there has been a massive investment in digital technology and fiber optics. For example, AT&T's gross rate base has grown from about $13 billion in 1984 to a forecast $16.9 billion as of 1987. In other words, almost one-fourth of AT&T's plant is four years old or less. The money spent for digital technology and fiber optics increases opportunities for new services, increases capacity, and substantially lowers costs. These circumstances provide AT&T the opportunity to increase profits without enhancing efficiency, innovation, or any other of the reputed incentives of price caps, but simply by processing larger call volumes through fixed-cost facilities. It doesn't take a financial wizard to figure out if you can make 30 percent more calls without increasing costs your business will become extremely profitable. Furthermore, these factors may represent a one time opportunity. At least one interexchange carrier, MCI, has preferred that the long distance carriers have now realized the major economies to be achieved in long distance operations. Thus, no new surge in investment will be necessary to maintain efficient operations.

Without the safeguards of traditional rate-of-return regulation, the benefits of the technological advances and their associated cost reductions will not be passed onto ratepayers as they would under cost based regulation. The evidence suggests that the interexchange telecommunication industry is a declining cost industry. Telecommunications regulation exists because of the monopolistic structure of the telecommunications industry and the need to protect ratepayers from abuses of monopoly power while inducing economically efficient delivery of services to the public. The theme underlying the FCC's price cap proposal, however, is that competition exists or is in sight in the provision of basic interstate telephone service, and, that a more relaxed form of regulation may now suffice. Despite the divestiture and despite the emergence of competition in certain segments of AT&T's historic monopoly area, that company still retains enormous market power and, if ineffectively restrained, could use it to the detriment of the public.

The FCC in its Further Notice states that consumers will be protected by a price cap adjustment mechanism, consisting basically of a price index modified by a productivity index. No evidence exists that this mechanism will capture decreasing costs for consumers. The Commission concedes that it cannot itself directly measure productivity in the telecommunications industry, in part because companies will not make the relevant data available. The Maryland experience indicates the lack of this ability will be used to the detriment of ratepayers. AT&T of Maryland for the 12 months ending March 1987 reported operating income of $9,122,000 for a 125 percent return on rate base. To allay fears of the Maryland Commission that it would continue to earn excessive profits AT&T of Maryland stated that:

The reported earnings are not indicative of future results because the going-level adjustment for the February price changes is stated on a stimulated basis. Revenue and access charges realized since the price changes were effective, indicate that the annual reduction to net operating revenues will be $12.0 million instead of the $8.0 million utilized in calculating the reported results. Since anticipated stimulation

has not yet occurred, AT&T excepts annual operating income and revenues to be $2.6 million and $116 million respectively. These anticipated results would produce an operating margin of 2.2 percent.

For the twelve months ending March 21, 1988, AT&T of Maryland actually earned $14,972,000 or 570 percent over projections. (See attached Chart of AT&T of Maryland Book Returns).

The FCC would have consumers rely on its price cap adjustment mechanism for assurance that ratepayers will significantly share in productivity gains. In doing so, the Commission has decided on a high-stakes gamble with the dollars-and-cents interests of ratepayers—a gamble estimated by some analysts as having stakes equal to $500 million per year for each percentage point by which productivity is underestimated. No gamble is involved, however, for carriers, inasmuch as the Commission has decided not to seek to recapture the potentially great profits that carriers would pocket as a result of a seriously underestimated productivity adjustment factor (§ 474).

The FCC, unfortunately, provides only vague assurances that it will prevent excessive earnings from arising. In Maryland the residential ratepayers receive some benefits from cost reductions because AT&T of Maryland is required to continue to report its extraordinary level of earnings. It is evident from an examination of the pattern of AT&T price decreases in Maryland that it is the disclosure of their extraordinary earnings levels which has led AT&T of Maryland to reduce rates. In an effort to escape the pressure to reduce rates caused by the Commission's filing requirements, AT&T has attempted to change its reporting requirements to reflect an operating ratio rather than the traditional earned return analysis. The effort has so far failed. In contrast to the Maryland Commission which has at least tracked the results of its decision, FCC would rather be in the dark, preparing to deny itself the information base required to monitor earnings effectively. Carriers electing price cap treatment will, for example, be greatly exempt from Part 65 reporting requirements, except for minimal annual filing of highly aggregated total return data. (Further Notice § 509).

The danger of price cap regulation is that AT&T will point to declining price as evidence that price cap regulation is working. Given the declining cost curve present in the telephone industry, prices should come down, not remain stable. The issue is whether price cap regulation captures more gains for consumers than rate-on-return regulation. AT&T has realized at least 18.0 million dollars in excess profit in Maryland through December, 1987. These funds can never be returned to ratepayers. As long as AT&T retains maket power and unlimited profit potential, it has little incentive to share cost savings with its customers.

CONCLUSION

A tested method exists for providing an effective control on the monopoly power of AT&T, rate-of-return regulation. This system is in place and need only be vigorously applied by the FCC to continue to secure premium service at low prices to the vast majority of the public. An empirical study done by the Consumer Federation of America in reponse to the FCC's price cap proposal concludes that during the era of rate-of-return regulation, one can trace a clear line from research and innovation, through capital accumulation, to declining consumer prices and increasing market penetration. Consumers have benefitted handsomely from rate-of-return regulation with the rate of increase increase in price for telephone service having been about half of the rate of increase for all items since the establishment of telecommunications regulation. This record is unparalleled among other categories of consumer expenditures.

For the various reasons discussed above, the Office of People's Counsel believes that the price cap model of regulation would not be an improvement over rate-of-return regulation. This system would only serve to benefit AT&T at the expense of its ratepayers—especially average residential and business customers who comprise the Company's most secure (and captive) market.

AT&T OF MARYLAND, INC.—BOOK RETURNS

[Dollar amounts in thousands]

Year ending	Revenues	Net income	Percent of return
Dec. 31, 1984	$118,471	$555	10.92
Mar. 31, 1985	124,892	2,546	43.89
June 30, 1985	127,468	2,949	48.63
Sept. 30, 1985	129,960	2,211	65.65
Dec. 31, 1985	132,144	4,661	67.97
Mar. 31, 1986	128,973	3,745	27.26
June 30, 1986	122,817	2,227	15.86
Sept. 30, 1986	127,879	15,616	93.4
Dec. 31, 1986	125,854	10,713	91.08
Mar. 31, 1987	124,524	11,439	125.40
June 30, 1987	123,733	10,224	99.28
Sept. 30, 1987	123,822	11,019	76.29
Dec. 31, 1987	122,355	12,142	86.65
Mar. 21, 1988	123,722	14,972	108.56

Senator INOUYE. Thank you, Mr. Glynn.

Now we will hear from the President of the Communications Workers of America, Mr. Morton Bahr.

STATEMENT OF MORTON BAHR, PRESIDENT, COMMUNICATIONS WORKERS OF AMERICA, AFL-CIO

Mr. BAHR. Thank you, Mr. Chairman.

I am Morton Bahr, President of the Communications Workers of America.

CWA represents about 700,000 workers, of which 550,000 are employed in common carrier telecommunications, most of them in AT&T and the Bell operating companies.

When the FCC proposed its price cap style of regulation, the agency was recognizing that times have changed for the common carriers. Today, the climate is competitive.

Ever since the Commission adopted its first and second proposed rulemaking notices, millions of words have been written and spoken about various concerns over the price cap regulatory style.

The concerns have been about quality of service and the ability of competiters to compete. To date, too few genuine concerns have been expressed about the adverse effects that have been visited on the people employed in the industry.

The notable exceptions earlier this year were Chairmen John Dingell and Edward Markey and a few of their House colleagues, who recognized that there is a human element involved here, not merely a group of economic abstractions.

So, Mr. Chairman, I would like to thank you for the invitation extended to me to be here today.

Highly skilled workers with years of service have been fired, transferred or downgraded with little regard, and family pressures have intensified. Documented evidence exists of sharp increases in alcohol abuse, drug dependency, and suicide rates among our members and their families.

These members have suffered great emotional and mental trauma. Lives have been literally destroyed, families broken up, and those who remain employed work under the constant fear and insecurity of losing their jobs in the current environment.

Last week, CWA filed comments in support of the Commission's proposal, with the understanding that service quality would be protected.

We do expect the Commission to amend this proposal to meet the legitimate concerns of many commenters in the industry. But in assessing the price cap regulation proposal, we are keeping in mind that it is not an abandonment of regulation.

CWA's position has evolved as a result of the changes in the industry over the last decade, and especially since the 1984 AT&T divestiture. The Bell system breakup was the direct result of many forces converging at a time when competition within the telecommunications industry had become robust.

Today, nearly five years after that breakup, even more robust competition has settled into most areas of the business, with the exception of residential and small business users of local service.

Today, only AT&T, the BOCs and other LECs are pervasively regulated by the FCC. Their competitors have enjoyed full access to the telecommunications market, without significant restrictions.

CWA's position is that adoption of the price cap regulatory style, with the proper safeguards proposed and enforced by the Commission, should bring fairness to the competitive marketplace and provide for a more level playing field.

I often encounter those who are surprised to learn that AT&T's major long-distance competitor, MCI, is more than 20 years old. It came into existence as a result of Commission and court decisions allowing an artificial and wholly unfair form of competition, including deeply discounted network access charges.

In our price cap docket filing of last week, we asked the Commission to decide how many more years of shelter are to be provided in what is alleged to be a competitive marketplace. Those opposed to changing the present regulatory system, meanwhile, insist, as we heard a little earlier, on citing misleading figures that AT&T has a 72 percent, and up to 80 percent, share of the long distance market. What they fail to state is that the inflated market share figures that they quote include all of the residential customers who seldom use long distance, customers whose bills fall into the five and ten dollar a month rate. And, I might ask, when was the last time you saw one of AT&T's competitors advertise on television for residential customers?

The competition today is for the large business user, and in this market, AT&T's share is closer to 50 percent.

My union represents several hundred thousand American men and women who have come through the process of divestiture.

Many were displaced and disadvantaged, victims of abstract economic theory and a Communications Act which were not consonant with one another.

For the last 15 years, the Congress has examined the Communications Act and has not come close to amending it to reconcile competition and regulation. As of today, we do not see any kind of consensus for legislation.

In taking our position on Federal price caps, we assess the service quality issues set out in the Commission's further notice of proposed rulemaking. We urge the Commission to clarify certain items to assure the public that the first rate telephone service, to which we have become accustomed, will continue.

We believe an incentive form of regulation can be tried without harm to users, shareholders, and the employees in the industry. We believe the cause of fair competition can be served by the Commission's plan once it is perfected.

Thank you.

[The statement follows:]

STATEMENT OF MORTON BAHR, PRESIDENT, COMMUNICATIONS WORKERS OF AMERICA, AFL–CIO

My name is Morton Bahr, President of the Communications Workers of America, an affiliate of the AFL–CIO. CWA represents approximately 700,000 workers of which 550,000 are employed in common carrier telecommunications, most of them in American Telephone & Telegraph Company and the Bell Operating Companies.

When the FCC proposed its price cap style of regulation, the agency was recognizing that times have changed for the common carriers. More than two decades ago, the pervasive monopoly of end-to-end service, with fixed responsibility, began coming to an end.

Today, the climate is competitive. The Commission has decided—for those carriers so electing—to regulate in a way to reward them for efficiency. Thus, American Telephone & Telegraph Company, the Bell Operating Companies and other local exchange carriers would be allowed to retain profits without regard to the current rate base, rate of return style of regulation.

Ever since the Commission adopted its first and second proposed rulemaking notices, millions of words have been written and spoken about various concerns over the price cap regulatory style. The concerns have been about quality of service and the ability of competitors to compete. To date, too few genuine concerns have been expressed about the adverse effects that have been visited on the people employed in the industry. The notable exceptions earlier this year were Chairmen John Dingell and Edward J. Markey and a few of their House colleagues, who recognized that there is a human element involved here, not merely a group of economic abstractions.

Highly skilled workers with years of service have been fired, transferred or downgraded with little regard.

Family pressures on our members intensified. Documented evidence exists of sharp increases in alcohol abuse, drug dependency and suicide rates among our members.

Our members have suffered great emotional and mental trauma. Lives have been destroyed. Families broken up. Those who remain employed work under the constant fear and insecurity of losing their jobs.

Last week, the Communications Workers of America filed comments in support of the Commission's proposal, with the understanding that service quality would be protected. We do expect the Commission to amend its proposal to meet the legitimate concerns of many commentors in the industry. In assessing the price cap regulation proposal, we are keeping in mind that it is not an abandonment of regulation, nor is it a device to hide telephone rate increases. This regulatory mechanism applies to the *inter*-state portion of telecommunications, presently under the Commission's jurisidiction. It is not a Federal pre-emption of the States' rate and service regulation.

CWA's position has evolved as a result of the changes in the industry over the last decade, and especially since the 1984 AT&T divestiture. The Bell System break-

up was the direct result of many forces converging at a time when competition within the telecommunications industry had become robust; today, nearly five years after the breakup, even more robust competition has settled into most areas of the business, with the exception of residential and small-business users of local service. The Commission has committed itself to protecting these users, and the Congress and Federal courts can be counted on to ensure that the Commission does its job properly.

Today, only AT&T, the BOCs and other local exchange carriers are pervasively regulated by the FCC. Their competitors have enjoyed full access to the telecommunications market without significant restrictions. For a current example of the abuses of unrestricted market entry, I cite the practices of some providers of "Alternative Operator Services," who have been shown to charge up to $10 or $15 more than the established carriers, that is, AT&T and the local exchange companies. CWA's position is that adoption of the price cap style of regulation, with the proper safeguards proposed and enforced by the Commission, should bring fairness to the competitive marketplace and provide for a more level playing field.

I often encounter those who are surprised to learn that AT&T's major long distance competitor—MIC Communications—is more than 20 years old. It came into existence as a result of Commission and court decisions allowing an artificial and wholly unfair form of "competition," including deeply discounted network access charges.

In our price cap docket filing of last week, we asked the Commission to decide how many more years of "shelter" are to be provided in what is alleged to be a "competitive" marketplace. The AOS companies and various toll competitors continue to seek "shelter" from the forces of competition in the market, which, we are told, should be the ultimate place to determine success or failure.

Those opposed to changing the present regulatory system, meanwhile, insist on citing misleading figures that AT&T has a 72 to 80 percent share of the long distance market. What they fail to state is that the inflated market share figures they quote include all of the residential customers who seldom use long distance, customers whose bills fall into the $5 and $10 range. When was the last time you saw one of AT&T's competitor's advertise on television for residential customers?

The competition today is for the large business user.

CWA represents several hundred thousand American men and women who have come through the process of divestiture; many were displaced and disadvantaged, victims of abstract economic theory and a Communications Act which were not consonant with one another. For the last 15 years, the Congress has examined the Communications Act and come close to amending it to reconcile competition and regulation; as of today, we do not see any kind of consensus for legislation.

In taking our position on Federal price caps, we assessed the service quality issues set out in the Commission's Further Notice of Proposed Rulemaking. We urged the Commission to clarify certain terms to assure the public that the first-rate telephone service to which we have become accustomed will continue.

The comments and replies to be gathered by the Commission by the end of August may very well cause the agency to redraft its proposal. We believe an incentive form of regulation can be tried without harm to users, shareholders and employees. We believe the cause of fair competition can be served by the Commission's plan, once perfected.

Senator INOUYE. Thank you very much, Mr. Bahr.

If I may, I would now like to call upon a very important Member of the Committee, Senator McCain, for questioning.

Senator MCCAIN. Thank you very much, Mr. Chairman. I would like to thank you, Mr. Chairman, for having this hearing. I think we are talking about a very complex and important issue, one that affects the daily lives of virtually every American.

I would like also to thank the members of the panel for their patience and for their important testimony that we have had here today.

I would like to ask just a couple of questions, and perhaps we can make the answers as brief as possible, since I know that every member of the panel has a view on questions that I would like to ask.

Starting with you, Mr. Bahr, and going around the table, I would like to ask if you believe that price caps will give telephone companies the ability to lower rates where they face competition and raise rates where there is no competition.

Mr. BAHR. I think that would always be a possibility. But this is not a form of deregulation. The regulation would still be there, and that is a role that the regulators should play, to see that that does not happen.

Senator MCCAIN. Thank you.

I would just like to go right around the table, if we may.

Mr. MARSHALL. Fine, Senator McCain. I am Charles Marshall of AT&T.

One of the reasons that we think there should be a modification of the currently proposed plan is that we would like the freedom to reduce rates more than the 5 percent indicated in the plan, precisely for the reason you describe.

We think to benefit the consumer, if there is an opportunity to reduce price, it should be done. It should not be delayed over several years.

But we do not have an objection to a price cap or a lid to protect services in those areas where some people feel that we would do something that we would never do.

So I think the current plan protects the consumer in giving him breaks and lower prices, protects him on the topside in that his prices will not go out of control.

Senator MCCAIN. You are not concerned about areas where there is no competition?

Mr. MARSHALL. There are no areas like that, Senator.

Senator MCCAIN. In rural areas there are.

Mr. MARSHALL. Not in very many rural areas. In those areas, we have a national geographic average, and we intend to keep it. We said so, and I was delighted to hear the Chairman of the FCC say so.

It has been a hallmark of our business reputation and we intend to keep it, that we will charge the same rate everywhere in the country.

I see your concern, though.

Senator MCCAIN. Mr. Kovach.

Mr. KOVACH. Senator, I think that is a very real concern and particularly in those areas where competition does not exist. That was part of our comments that we filed before the FCC, particularly as it relates to local exchange carriers.

I think if you listened to Chairman Patrick's testimony this morning, he as much as admitted that even today, under the rate of return regulation, there is cross-subsidization and discrimination that they feel they are not able to detect.

Under a price cap regime, which is a lesser form of regulation and allows much more flexibility, I think that is a far greater concern, particularly where there is no competition to offset those kinds of initiatives.

Mr. HASSELWANDER. From an LEC point of view, our customers are not the end consumers. Our customers are the inter-exchange carriers—MCI, AT&T, my own company, RCI—and there is really no incentive to do that, to price discriminate.

We are dealing with large customers who have a lot of market power.

Mr. McArton. As far as the small companies out in the rural areas that you speak of and which we represent, under the pooling concept that we now have and will be continued, we were assured this morning and we're asking for even greater assurances, what we are going to have is averaged national access charges for that group that remains in the pool, and we have the averaged toll rate guarantee given us by AT&T and Chairman Patrick. So, in our case, as long as the pooling mechanisms are kept intact, I would say that our prices, the cost of long distance service in our areas, will remain in an area that they should be and much better than if they were cost based on the high cost-low volume routes.

Senator McCain. Mr. Skinner.

Mr. Skinner. Senator McCain, I think it is important to point out, right at the outset, that from the local exchange carrier standpoint, the customers we are talking about are the inter-exchange carriers.

But the, further with respect to the price cap regime, it seems to me that it is logical that it can have its best benefits in areas where there is less competition, for the simple reason that competition will tend to make the carriers more attentive to getting the prices at the right level because of the thrust of that competition.

If you are talking about rural areas, I am not going to get into the debate about where there is competition and where there is not. But I think it is logical to conclude that price cap regulation will tend to drive prices down in areas where there is not as much competition.

Mr. Shreve. Senator, I think there would certainly be the possibility of that happening, and, within the bands, that they have that flexibility. I think also there would be the concern of a possible lack of investment in areas that would not be as profitable as there were in areas where the competition was, so there might be a decline in service.

So I think you would have a two-fold concern that you would have to face there.

Mr. Glynn. Senator, I think as I noted when I discussed in my testimony the behavior of AT&T in Maryland with respect to weekend and nighttime rates, I think what you will see in this declining cost industry is something much more insidious than rate increases for one customer class and decreases for another, because people react to that when their rates go up.

What you will see is the lion's share of the investment the lion's share of the innovation, the lion's share of the reductions—and there will be reductions, inevitably—flowing to those customers with respect to whom AT&T sees the most competitive threat.

I think it is totally illogical to suggest that any utility will voluntarily decrease rates if it can avoid it more than is necessary to customers with respect to whom there is no competition.

Senator McCain. I hope you also share my concern about the continued existence of programs, such as the Lifeline Program, and others which have been put into place to provide senior citizens and others an ability to communicate.

Mr. GLYNN. I think you make a very critical point that we have been able to implement those programs under rate of return regulation, and we now have a system that, at least in Maryland, approaches universal service to both the poor and the rural customer.

Senator MCCAIN. Let me just follow up with you and Mr. Shreve.

I think your points are well made. But don't the States and the FCC have an obligation to monitor this quality and the continuation of such programs and others that if they were—and let me play Devil's Advocate—if you were doing your job, then these things would not happen?

How do you respond to that?

Mr. SHREVE. I think you are right. I think one of the largest criticisms that is being made right now of rate of return regulation is not so much the system as possibly different agencies not doing their job.

One of the criticisms of the present system is that companies have put in fat, have padded their investment, their costs.

Now, if that is the case and they have done that to further their profits by having a large rate base, then you put in the price cap, so would those same companies not then take away that fat, take away that investment so that they would further their profitability, as well as look at the areas that it might not be as profitable to put that investment in, so that by holding off on some of the rural areas, by holding off on that investment, it would further their profitability?

So, if you are talking about a criticism at this point because things have fattened up and because there is the padding there, and if you take the reverse of that, and if there is an area where they can slack off on putting the investment in to further their profits, I think the concern should certainly be there.

Mr. GLYNN. I would just like to add that I think you are correct.

The States do have this obligation that you refer to. However, the bulk of the State's energy—the Maryland Public Service Commission and my office, which are separate agencies, totaling about 160 employees—is directed toward the intrastate companies—C&P of Maryland, Baltimore Gas and Electric, Pepco, all of these various companies.

The FCC has the primary responsibility for maintaining and supervising this matter with respect to interstate carriage.

I think there is a problem. They proposed this proposal because they do not think they can effectively maintain rate of return regulation. What makes one think they can do their job with respect to service quality—and it is a big job?

Mr. MARSHALL. Senator, may I just make one further comment in light of Mr. Glynn's comment here?

Senator MCCAIN. Certainly.

Mr. MARSHALL. I appreciate and we respect that Mr. Glynn and others like him want to overlook quality and have an interest in it. I would offer to you, though, that the quality in the AT&T and its predecessor organization, the Bell system, was a voluntary imposition put on by that industry.

It was done because we have customers. We absolutely respect the fact that if we do not give high quality service to our custom-

ers, they now, in the new world, can work away. Before they could only criticize.

So, I don't think you are going to see any jeopardy to quality because it is just not in our bones to do it that way. Customers in a competitive world would tell us very quickly that they didn't like it.

Mr. SKINNER. May I comment, Senator?

There have been a number of references to quality and the notion that perhaps quality would be neglected under a price cap regime.

I think that is a self-defeating course. It seems to me that that is a false notion, that the carriers would engage in that kind of thing, for several reasons.

First of all, as far as the local exchange carriers are concerned, our pricing is based on the completion of calls through the network. And so, the more efficient we can make the network, the better service we can provide, logically the more revenue is going to flow from our standpoint.

So that is the first argument.

The second one is this. I think anybody who has spent anytime in the telecommunications business would agree that to give poor service is going to increase costs, not reduce them. There is no doubt that additional investment to improve efficiency is also going to provide better service.

And so, from a revenue standpoint, it would make sense that we would give good service. From the standpoint of what would happen as far as expense is concerned, recognizing it would go up if we gave poor service, it seems to me that says pretty clearly that it is in our best interest, if in nobody else's, to give good service.

There is also the element of competition and the fact that there is the opportunity now to bypass.

Then, fourthly, there is the reporting that is required on a semi-annual basis to the FCC, as far as service quality is concerned, and also the State commissions require service reporting.

And so, when you consider all of those factors, it is hard to conclude that the local exchange carriers are going to abandon their traditional commitment to service quality.

Mr. HASSELWANDER. Senator McCain, may I just add to that?

I agree with what Mr. Skinner says. I would just further point out that this industry measures itself and measures itself through its customers very well and very effectively.

We have between 100 and 200—I have lost count—measurements that we do each month. We call our customers who have had dealings with us each month and we measure ourselves very carefully and react as part of that.

The Public Service Commission in New York and the commission in Pennsylvania, where we do business, require us to report those results, and they monitor those very closely. They audit those as appropriate.

I think that is an important factor.

Senator MCCAIN. As always, Mr. Bahr, the last word.

Mr. BAHR. I would just reiterate, as a representative of the workers, I can tell you of this management's—and I include them all—commitment to service. In fact, we probably have more arguments

over the degree of pressure on employees to produce the kind of service they are talking about.

I think it is absolutely unreal to think that any type of change in the method of regulation could change this hundred year old tradition.

Senator McCain. Mr. Bahr, I hesitate to disagree, and I do not. But I also hope you appreciate our concern, as yours, that quality of service is maintained particularly in areas where there is no competition.

I also do not want to get into a debate as to where there is competition and where there is not.

Also, certain programs which are not profitable for the phone companies today, such as the Lifeline Program and others, need to be preserved so that we can provide Americans with the fulfillment of part of the American dream, and that is their ability to communicate with their family and loved ones, particularly in time of emergency.

Mr. Bahr. Sir, let me just point out to you in that area that Congressman Wyden, I think of Portland, introduced the concept that Pacific Northwest Bell was providing free service to senior citizens' homes and things of that nature, and our members are putting in the phones on their own time. That is not going to change.

That is going to increase across this country with the help of Members of the Senate and the House who encourage it to happen.

So I think we are in an industry that has great tradition to provide the kind of service that no other country, to this day, provides.

Senator McCain. I am sure this has gone on for a long time, Mr. Chairman, but I appreciate what we have heard here today. I think it has added a great deal to our understanding of this issue.

Thank you, Mr. Chairman.

Senator Inouye. Thank you.

I believe all witnesses have agreed that our system is second to none, and those who support the price cap proposal have argued that in order to maintain this level of second to none, and especially in an atmosphere of "vigorous competition," the price cap proposal is necessary if we wish to increase the quality of service, if you wish to encourage innovation, and if you want to raise the level of productivity.

We have four witnesses who have spoken in favor of the proposal and four against.

For those who question the FCC's price cap proposal, what have you got to say about the proponents who suggest that it is necessary if all these things are to happen—innovation, quality of service, level of productivity?

Mr. Kovach. Mr. Chairman, I think we have seen in the industry today, particularly in the areas where competition is present, a very vigorous rate of innovation, new technology being introduced, new services being provided.

I do not think it is a question of going to another regulatory regime that is going to continue that stimulation. I think it is the fact that where competition exists, that is the way that one goes out and tries to achieve new customers.

If that is there, then I think you are going to see continued efforts to essentially do the kinds of things that we are all looking to

have done in terms of our communications system and communications network.

I do not think that price caps or any other regulatory change is going to essentially change that. I think we have heard comments here that this industry has a tradition, even in the local exchange network, of providing that innovation, providing that type of high level service.

I don't think that is going to change as a result of going to price cap. I don't think price cap is a necessity. To do that, in fact, for all the reasons that we have heard from the standpoint of concerns about prices, really concerns about where price caps might take us in terms of either service quality or prices, are reason enough that price caps, I think at a minimum, deserve a much more intensive look by this Committee and the FCC before it moves forward.

Mr. McARTON. I was trying, I guess, to be a little more neutral than opposed.

Where I am coming from is we do not, the small companies do not oppose the price cap regulatory scheme.

What we are concerned about is where the small companies that are going to continue in the rate of return pooling arena on the interstate—in other words, the NECA pool members—that we need the necessary safeguards of the Unity Agreements and the support funds, universal service funds, and we are simply asking that this language be included in any type of price cap proposal.

We do not disagree that the price cap type of regulation is needed by local exchange carriers. We are just saying there is possibly 800 or 900 out there that may not opt for it, and we need the safeguards to make sure that the universal service fund, average toll rates, and the support funds that were guaranteed under the Unity 1-A scheme are there.

I am not, NTCA is not sitting here opposing the price cap plan.

Mr. SHREVE. Sir, NASUCA is opposing the price cap plan, as written, for several reasons.

For one thing, the innovations that we would look forward to in producing greater services in great part have already been paid for, starting by customers under rate of return regulation. Depreciation that has been paid for by the customers will also provide a large margin of those profits.

The option plan, where the company may either opt in or opt out of the rate of return or the price cap mechanism would put each individual company in the position of benefitting itself most, putting itself into the plan which would benefit itself most, probably by profits.

I think what we are seeing now in most of the States and at the Federal level is a high earnings situation, which now will not benefit the rate payer as it would have under the rate of return system.

If you are having these high earnings that are already built in and will not be provided by innovation or by incentives, but are already there, then the benefit that is really deserved by the customers will not be received.

I don't think there is going to be that much of a change in the quality of service. I think that probably is going to continue. And, as everyone says, we do have a very good system relative to the rest of the world.

However, that is the system that was produced by the rate of return system.

I do not look at the rate of return system as a cost-plus. It certainly should not be a cost-plus system if the regulators are doing their jobs.

Now, perhaps we need more advocacy to point out where there is the fat and where there is the padding. But you cannot let a system go into place with that padding and fat into it and then let that padding and fat be removed by the companies and those profit inure to the benefit of the companies rather than the customers, who have been paying for it over the years.

Senator INOUYE. Thank you.

Mr. Glynn.

Mr. GLYNN. Thank you, Senator.

As the predicate of your question suggests, I think, and as I think everybody here today agrees, the case has already been made that rate of return regulation, traditional regulation, can produce an innovative, technologically advanced, and extremely adequate system available to everybody, or almost everybody, out there, all members of the public, even the poor and even the rural.

That case has been made.

Now we have these companies and the FCC coming forward not with a case, but with naked assertions that, even though we have prospered under rate of return regulation, even though we have created an innovative and technologically advanced system under rate of return regulation, it has got to be abandoned, it has to be changed, and we have to do this a different way or terrible things will happen.

The case has not been made.

I would suggest to you that a wiser and more reasoned course would be to continue adjusting rate of return regulation, employing experiments perhaps such as that discussed by Commissioner Schwartz from New York State, which are variations and modifications on rate of return regulation, in order to explore whether or not AT&T and its alleged competitors can, in fact, make the case they claim they can make over a period of time, rather than abandoning a system that has already proven that it will work, even though it is not without flaws.

Senator INOUYE. For those who support a price cap, how do you react to the claims made by the last two witnesses, that it was the rate of return approach that developed the second to none system, that it encouraged innovation that resulted in a high level of productivity and high quality system?

Mr. SKINNER. Mr. Chairman, if I could comment, I think we need to emphasize the fact that we are in a changing environment, a rapidly changing industry, with technology driving much of that change and competitive entry driving much of that change.

So, I am certainly not here today to condemn the rate of return regulation approach, but simply to underscore the importance of recognizing the changes that are taking place about us. To simply say that we ought to continue in the future because of what has happened in the past I think is short-sighted indeed.

I think there are two principal points that I would want to emphasize.

First of all, with respect to the consumer, the consumer gets an up-front guarantee of a reduced rate—$1.6 billion, as a result of the consumer productivity dividend in the formula that has been advanced by the FCC.

And so, clearly, there is the immediate advantage from that standpoint.

Secondly, I think a key word is "incentive." It is not that there has been no incentive in the past, and I certainly would not say that "terrible things" will happen if no change is made.

I think the point is that better things will happen if the change is made and that the future would be brighter. There would be a better opportunity to develop the full capability of the industry in this nation with more regulatory flexibility of the kind that price cap regulation would afford.

So I think the point that I would want to end on is that what price cap regulation would offer would be additional incentive to do more to try to make the system more efficient, to do more in the way of investment, to try to enhance the service, the network, and to try to make sure that we have not just downside risk of something new, which is what we have frequently under rate of return regulation, but we also have the opportunity for a commensurate reward on the upside.

Senator INOUYE. Mr. Hasselwander.

Mr. HASSELWANDER. Thank you, Mr. Chairman. I would like to focus on the issue of innovations and indicate that, as a local exchange carrier, we are really faced with a dilemma in terms of innovations. That dilemma is this: those new services that may be provided are generally riskier than our basic business. They are riskier because customer demand is unknown. It is not entirely clear.

So, the question is do we want to make that kind of investment for a return which is an average kind of return that we get for basic, plain old telephone service. If I stop the question there, my answer would be no, I would not want to do that for that kind of return.

The other part of the dilemma, however, is if I do not do that, if I do not provide those services, somebody else will, and that will be the inter-exchange carriers.

To say that there is no competition in this market is crazy. I can see this from both sides, because I also have an inter-exchange company. I will tell you that right now, in New York State, we have proposals before the State of New York to bypass other local exchange carriers because services are not there—high density pipes, for example, which we call "T's" or "DS-3s."

So I think it is important, that this kind of incentive plan is absolutely important, if we are going to see innovations in the long-term in this country.

Senator INOUYE. Mr. Marshall.

Mr. MARSHALL. Mr. Chairman, you began this by discussing the changes in the industry and that some people say that maybe the new form of price cap's time had come, or something to that effect.

Let me just briefly go back.

Rate of return regulation was the only form of regulation that would do the job with a monopoly, and that is what we had. It

stood up for the consumers. It stood up for the customers, as I prefer to call them. Someone stood in for them and judged whether or not prices were right.

But that is not the kind of world we are in today. Wearing an AT&T hat, we are in a very, very competitive world.

First, let me say that under rate of return regulation, service was good and it continued to be managed well, and it was a very compatible relationship. That same thing can be true under rate of return regulation going forward, but not as well as price cap. This is because under the price cap regulation, AT&T, in fact, will be able to bring on products more quickly—as quickly as my friend from MCI.

We are in a competitive marketplace. We would like to be able to bring out new products, new prices, attractions for the customer, much more quickly than we can today.

An example of what can happen might be that several years ago, the consumer products marketplace was opened up, from being something rented by the telephone company in pretty much a monopoly mode into a wide-open marketplace. The beneficiary of that has been the customer. It has been a variety of products. It has been extremely attractive prices, and the businesses that have done it have been profitable doing so.

This is because it released an energy among people in the business—our company and others—to find better ways than they had in the past.

Now, it is a shame that we could not inspire that under rate of return regulation. But it is a fact that it became a much more inspired move under the freedom to price and move and satisfy the customer.

Senator INOUYE. Mr. Bahr, some have suggested that under the FCC price cap proposal, there will be a reduction in the workforce.

Mr. BAHR. Well, I would relate what my colleagues just said to your last question as being quite contrary to that, because both as AT&T is able to react to the marketplace in a much quicker way than they can now, as well as bringing new products and new lines of business on line, that is going to create jobs.

But, more specifically, in response to Chairman Dingell and Representative Markey, in writing, AT&T has said that not only would the price caps not reduce the workforce but, quite the contrary, it could be expected to grow, and that is in a written response. I believe that to be true, not only of AT&T, but the LECs as well.

Senator INOUYE. Some have suggested that the public interest would be served if we extended the comment period and permit others to participate. Those who support the price cap, what do you have to say to that?

Mr. Hasselwander.

Mr. HASSELWANDER. Mr. Chairman, the price cap proceeding, has already been going since August of 1987, and that is following discussion on these issues that had gone on several months before that. So it is not as though it is a young hearing or inconsistent with these things in general.

If we delay this, we delay the benefits to consumers, and I think that has to be carefully weighed. And I do not think it is a matter

of delaying it from now to January or February. I think if we delay it now, we are probably looking at a much longer delay.

I feel that way because the players will change, institutional memories will be destroyed, and the record that we have will have to be redone and reinstituted.

So I think that we would be looking at a long delay and I think that would be a shame.

Mr. SKINNER. Mr. Chairman, I would like to add my own comments.

I agree totally with what Mr. Hasselwander has said, and underscore the fact that there is $1.6 billion in customer benefits that would immediately begin to flow at the beginning of a price cap regime.

The process has been working now for quite some time, and it would certainly be our urging that we let the process work and not impede that process.

Senator INOUYE. How did we arrive at this $1.6 billion consumer benefit?

Mr. SKINNER. The $1.6 billion is what is represented in dollar terms by the 0.5 percent consumer product dividend in the formula that has been devised by the FCC. That is the factor, in addition to what is judged to be the productivity offset, that the carriers would need to, in effect, provide to customers, whether we are able to achieve productivity levels at 3 percent or not.

In effect, it is a guarantee up front.

Frankly, I have great doubt that we will be able to achieve a 3 percent productivity figure on an annual basis.

Senator INOUYE. Mr. Hasselwander.

Mr. HASSELWANDER. I would just like to add to that.

In my own company, we have tried to assess in the short term what this proposal would do to our profitability.

It varies, of course, based on what assumptions you make about the future and what kind of exogenous variables will exist in the short-term, we probably are going to be slightly negatively affected, and for two reasons.

One, we already are very efficient, and it gets harder to achieve more efficiency when you are already efficient. But, even more importantly, our growth in usage demand in our territory is not very large.

Nevertheless, I think it is important that we go forward. This is not a short-term proposal. It is something for the long-term.

Mr. MCARTON. I would just like to state that the concern that we have do not have to delay the process. In other words, the Chairman spoke to our concerns in his testimony. All we need is to get these concerns into language with the price cap proposal. I do not perceive that as something that would have to delay this situation at all. I do not believe that there is a severe problem here. It is just that we must get the language that we need to assure our companies that what is happening now is going to continue to happen.

So I certainly think it can be resolved so that we would not have to delay the process.

Senator INOUYE. The $1.6 billion would be paid out over a period of four years, wouldn't it?

Mr. SKINNER. That's correct.

Senator INOUYE. So, would a delay, perhaps for six months or even a year, make that much of a difference?

Mr. SKINNER. Well, obviously, the sooner you start, the sooner those benefits begin to flow to the rate payer.

When you say "pay it out," you recognize, of course, that the consumer productivity dividend is a factor in the equation which works in setting the price. It is not actually a payout, but it redounds to the benefit of the consumer nonetheless.

So, if it is a sound concept, and there is a great deal of testimony in support of that, it would seem that there would be logic that says the process ought to continue to work and that we ought to move on with it.

Mr. HASSELWANDER. I would add that whenever this goes into effect—and let me focus on innovations again—there is not going to be an immediate reaction because the planning cycles and engineering intervals are likely to be a year or a year and a half.

Until we get those signals, it seems to me that we are going to go forward with price caps, those innovations, our ability to put those into the planning cycle, will not occur. So you are pushing something out. When you push out a year from an innovation point of view, you are really pushing something out farther than a year.

Mr. MARSHALL. Mr. Chairman, I think the savings are much larger than that, that is, the savings associated with the 0.5 percent dividend to people added to the productivity.

We believe that had this plan been in effect a year ago, the savings would be in multiple of billions already.

We know, for example, that every time we have gone before the Commission to attempt to come up with some attractive reduction in prices, whether you want to call it "Call One," "Reach Out America," or "Pro America" or any other package of that sort, under the current regulatory scheme, the way it works, we have been delayed anywhere from six, eight, ten months to a year or year and a half. Yet, when these are in place, the customers love them. They give them lower prices, real savings.

So, I would offer to you that, giving this a delay into next year—and I would agree that that means probably somewhat well into the next year—would be really to the detriment of the consumer.

There are five more months in this year for the plan to be looked upon, with comments again coming in on August 26, when we will all reply to each other's comments. I think there is time. There are differences, yes, but those differences are resolvable.

I think it is high time that we get on with it, honestly.

Mr. SHREVE. Mr. Chairman, I don't think it should be delayed just for the sake of delay. But I think if we are talking about an additional amount of study that would go into this system, primarily by Congress having additional input and studies done over a period of time, I think that would certainly be to the benefit of the consumer.

I don't think the question here is just necessarily how much the decrease that is initially offered or might even be forthcoming from this plan is the real question. I think the big question is if you are going to this type of plan, how much of a decrease is the consumer, is the customer, entitled to.

I think we have not even gotten to the bottom of whether or not the benchmark or starting point is correct. I think probably there is a great deal more money at stake here to the consumer than would ever be lost by any delay which would cost something there.

This is not a short-term measure that is being recommended. It is a very dramatic change that needs to be thoroughly studied to make sure that the consumer receives all of the benefits that he is supposed to, rather than just some token offering.

Senator INOUYE. Mr. Marshall.

Mr. MARSHALL. Mr. Chairman, I think one point we should make here is that this is not a change in direction with no other fluid ability to make change in the future. This is an attempt to put into place a three year trial plan of a different form of regulation, which would give us the opportunity to find the answer to the question Mr. Shreve just mentioned: what is the productivity saving that shows up under this plan? What does happen to quality? I think we will all find, very pleasantly, that quality continued to stay and continued to get better.

But, delaying finding out that information does not help anyone.

The Commission also has the oversight during that entire period and has the complete freedom at the end of that period to say that it is a bad idea, which I am sure they will not.

Senator INOUYE. In AT&T's filing, there is a suggestion that if the FCC plan had been in effect for the past two years, rate payers would have lost $2.4 billion because the FCC plan caps the common carrier line charge on a per minute basis.

Mr. MARSHALL. The FCC offers two alternatives for how they believe capping should exist for the LECs, and we believe the latter is the successful plan. That is compared to putting the cap on the line charge itself, rather than the minutes, the cost per minute.

We elect, we would suggest that the FCC should, in fact, put the cap on the line charge itself. Then, as volume increases, the access charge itself back to us and in turn to our customer would decrease as well.

We say to put it on a cost per minute basis would deny the customer that kind of saving. That is the basis on which that calculation is made. It is an argument for one alternative versus the other.

Senator INOUYE. Finally, as you may have noted, several of the Members of the Committee have expressed some doubt over the FCC plan that calls for optional or voluntary acceptance of the plan.

Should this be voluntary or optional?

Mr. MCARTON. It is our concern that it is and does remain a voluntary option for the small companies.

I guess the best way to put it is we would like the final proposal to make it permanently optional.

Senator INOUYE. So all of you are in favor?

Mr. KOVACH. Mr. Chairman, I think from our perspective, the optionality factor is one that basically was done as a political compromise with respect to local exchange carriers. We certainly do not feel that it is in the best interest necessarily of the consumer. I think those kinds of questions need to be reviewed very extensively, not only by the Congress but by the FCC itself.

I think in some respects, having optionality grants the local exchange carriers a choice that probably is not in the consumer's best interest but in the company's own best interest, and we don't think that is appropriate.

Mr. SKINNER. Mr. Chairman, we would support the option feature of the plan. I think it would be very, very difficult to expect a

productivity factor that would take into consideration some of the circumstances that the very small telephone companies are faced with. The plan ought to provide that option so that if a company elected to do it, it could feel that there was an opportunity to grow under that plan and not be forced into a situation where that opportunity was not there for them.

Mr. GLYNN. Senator, while I understand that there are valid reasons why some companies wish to opt out—and I have no position on that particular concern—while recognizing that the customers do not have the option to opt out in this particular plan, I think one technical concern is that if you try to maintain the expertise and the staff to regulate a variety of companies in a variety of ways all at the same time, you may only cause greater problems at the FCC concerning their ability to do both jobs both ways effectively, simultaneously.

Senator INOUYE. In five minutes, I must leave this place because a new Committee will be sitting in for a new hearing. So you have five minutes.

Mr. MCARTON. I would like to say that, as far as the small companies are concerned, we feel we are very efficient at this time. We feel that the fat trimming that has been talked about is not there in our companies.

I would like to relate the $100 widget that was brought up, that you could get for $50. I have a nine man board of farmers, and I can relate to you that if I am buying $100 widgets that cost $50, I would not be working for that company very long. The greatest job security that a small company manager has is running things efficiently.

So I do not think the efficiency factor really relates to the very small companies. That is why I think the plan should be optional to the small companies past the trial period.

Senator INOUYE. Mr. Skinner.

Mr. SKINNER. I want to make just one other comment in closing which has to do with customer opinion.

There is a nationally reknowned firm, a well respected organization, Cambridge Reports, Incorporated, which has conducted as part of an opinion survey an effort to get four questions answered having to do with price cap options.

There were 1,444 people surveyed in all walks of life, and, as a result of that survey, I think it is evident that public opinion strongly favors price caps. By a five to three margin, public response was that the government should limit prices for local telephone companies, rather than on the basis of earnings, in effect letting profits go up or down, depending on how that worked out. And 87 percent felt that the price they pay is more important than how much the companies earn.

Senator INOUYE. Mr. Glynn.

Mr. GLYNN. Senator, I have not said anything about the LECs during my discussion here today, the local exchange carriers.

While we may quibble about the level of competition that AT&T faces in the long distance market, there is no question there are vigorous companies out there attempting to compete with them effectively.

However, that is not true with the LECs. I think that the proposal to apply price caps to the LECs is far, far weaker than that to apply it to AT&T and the long distance carriers.

The Maryland Commission, which has permitted AT&T of Maryland to earn 125 percent on rate base, after an evidentiary proceeding concerning the level of competition faced by our own local exchange carrier, C&P of Maryland, has rejected C&P's argument that they face significant competition for all but a limited number of their services. Most people have no practical alternative. There is no meaningful competition for access, either when purchased by AT&T or when acquired by an individual, such as myself and my relatives in our own homes. That case cannot be made.

Mr. SHREVE. Mr. Chairman, I did not comment on the opting in and out.

I would be opposed to that. I don't think that a company should have the opportunity to decide from time to time which mechanism serves it best.

In the rate of return situation that we have right now, I think if it were to be continued and handled properly, regulated properly, then the benefits would by far flow to the consumer.

The statement has been made that under this price cap scenario, the rate payer would be better off than he is today. I think the question is would the rate payer be better off than he should be if rate of return regulation were proper and that the proper return on equity or proper profit were set, and that the benefits above that flow back to the rate payer.

We have always said in the utility business that the company is entitled to a fair return. We have never been able to argue that, even when rates were pushed too high. But now that rates could come down if a fair return were set, we're saying no, rates are too low, we're going to cap them. But what we really need to be talking about is bringing rates down.

Thank you very much for this opportunity.

Mr. HASSELWANDER. The regulators, while we have not commented on their discussion and their position, I would just point out that we ought to pay attention not to what they say so much as what they do. There are 28 states that have adopted already some form of incentive pricing.

Senator INOUYE. Gentlemen, I thank you all very much for your patience and your contributions here today. I can assure you of the interest of the Subcommittee. Their Members' presence here should be demonstrative of that.

We will be reading the transcript, and, based upon that, make our decision on the Kerry bill.

Thank you very much.

[Whereupon, at 1:52 p.m., the Subcommittee adjourned.]

[The following information was subsequently received for the record:]

STATEMENT OF THE ORGANIZATION FOR THE PROTECTION AND ADVANCEMENT OF SMALL TELEPHONE COMPANIES

The Organization for the Protection and Advancement of Small Telephone Companies (OPASTCO) appreciates the opportunity to submit this written statement to the Subcommittee on Communications. It is our hope that this statement will assist the subcommittee in its consideration of the Federal Communications Commisison's proposal to change the method of regulation for the interstate services of dominant carriers, specifically the FCC's price cap proposal.

OPASTCO is a national trade association representing more than 360 independently owned and operated small telephone companies in rural areas of the United States. OPASTCO's members, which include both commercial companies and cooperatives, range in size from 34 to 50,000 access lines. Collectively they serve more than one million customers in 39 states.

SUMMARY OF OPASTCO'S CONCERNS

1. OPASTCO generally believes the price cap concept could be beneficial to local exchange carriers, but major modifications to the FCC's proposal are necessary for price caps to be acceptable for small companies.
2. Small companies need a high degree of flexibility and should be afforded as many viable options as possible under any new regulatory format. Price caps should never be mandatory for small companies.
3. Any price cap plan adopted must include assurances that those small companies not electing price caps will not be adversely impacted.
4. The price cap plan must be structured so that it is a realistic option for small companies. The FCC's plan virtually excludes small company participation.
5. Certain aspects of the price cap plan must be modified so that they are less onerous for those small companies electing to participate in price caps.

OPASTCO GENERALLY SUPPORTS THE PRICE CAP CONCEPT, BUT THE CURRENT FCC PROPOSAL IS NOT ACCEPTABLE TO SMALL COMPANIES

Small telephone companies such as those represented by OPASTCO have particular concerns related to the FCC's proposal to replace traditional rate of return regulation with a system of price caps. While OPASTCO generaly supports the concept of allowing price caps as an option, the documents released by the FCC to date have not adeuquately addressed the concerns of small companies. In fact, the commission's Further Notice of Proposed Rulemaking issued May 23 virtually ignores small company issues.

Any regulatory scheme adopted by the commission for the telephone industry must address the concerns of small independent telephone companies.

PRICE CAPS SHOULD REMAIN OPTIONAL FOR SMALL COMPANIES

Basic to all of OPASTCO's concerns is the need for a high degree of flexibility for small companies because of the diverse characteristics and needs of the individual companies and their customers. By providing as many viable options as possible to small companies, regulators create the best environment for carriers to serve their customers and provide universal service. For this reason, price cap regulation should be an option and must never be mandatory for small companies.

SAFEGUARDS ARE NEEDED FOR THOSE SMALL COMPANIES NOT ELECTING PRICE CAPS

The vast majority of small companies will not elect price cap regulation. Instead, they will choose to remain in the pools administered by the National Exchange Carrier Association (NECA) or to file their own individual tariffs under the simplified procedures for small companies adopted by the FCC in CC Docket No. 86-467.

If price cap regulation is adopted as an alternative, the FCC must insure that those small companies not electing price caps are not adversely impacted. This includes preserving the provisions of the Unity 1A agreement adopted by the commission: a single, industrywide rate of return; a viable Universal Service Fund; and long-term support mechanisms. Many small companies will continue to rely on these principles.

Also, with the large carriers likely to leave the pools, NECA must be given adequate administrative and regulatory flexibility to adapt to its new makeup and to accommodate its remaining members.

To ensure these provisions, specific rules must be incorporated in the rules applicable to all companies, including those electing price caps. But the current FCC proposal does not provide the necessary assurances.

PRICE CAPS MUST BE REALISTICALLY AVAILABLE TO SMALL COMPANIES

If price cap regulation is adopted as an alternative form of regulation, that alternative should be available to small companies as well as large ones. But the FCC

proposal, as written, effectively eliminates the price cap alternative for nearly all small companies.

First, the timing included in the proposal is unrealistic for small companies. To file price cap tariffs in December 1988 for the proposed April 1, 1989 implementation date, companies must have elected to withdraw from both the traffic sensitive and carrier common line pools administered by NECA. The dates for opting out of the two pools are June 30 and August 31 respectively, meaning that small companies already would have had to decide whether to participate in price caps before even viewing the FCC's final order on the matter. At least one additional date should be established for small companies to elect to move to price cap regulation.

Also, it appears that the FCC proposal would require a small carrier to go through the following steps to be eligible for price cap regulation: already have notified NECA that it intends to exit the traffic sensitive pool; notify NECA that it intends to exit the carrier common line (CCL) pool; file its own traffic sensitive tariff on October 3 to become effective in January for three months; file a traffic sensitive price cap tariff on December 30 to become effective in April; file its own CCL tariff on February 1 to become effective in April. (Some of the specific tariff filing dates may change if the commission adopts another proposal released in June 1988.)

In addition, the simplified tariff filing rules for small company traffic sensitive tariffs do not seem to be applicable to the other tariffs, and the numerous filings would be quite expensive for a small company.

Many small companies, including approximately half of OPASTCO's members, are average schedule companies. These companies receive interstate revenues based on an average rate per call and per access line. The current FCC proposal is not clear for average schedules, but some commission staff members have indicated that average schedule companies would have to convert to cost before being permitted to use price caps. Ironically, average schedules already operate on a form of price caps. OPASTCO believes any price cap program must be readily available to average schedule companies, as well as to those operating on the basis of cost.

These provisions of the commission's proposal virtually eliminate small company use of price caps. The commission must modify its proposal to remove barriers to small company participation.

THE PRODUCTIVITY FACTOR AND PRICE CAP TARIFF FILING PROCEDURES MUST BE MODIFIED FOR THOSE SMALL COMPANIES USING PRICE CAPS

If any small companies are able and do elect to participate in price cap regulation, several aspects of the FCC proposal are particularly onerous for small companies and must be modified to make such participation realistic.

First, the productivity factor of three percent beyond the adjustment index already included in the price cap formula is completely unreasonable for small companies. The factor relies on historical measurements of productivity primarily based on AT&T and the Bell companies. Unlike larger carriers, small companies cannot easily lower costs by imposing efficiencies such as work force reductions when the average OPASTCO company has only eleven employees. Additionally, small companies are owned and operated by individuals living in the community, a fact which has always encouraged efficiency, productivity and innovation.

Technological upgrades have a much greater impact on the revenue requirement of small companies because of their size. Upgrading one switch could entail replacing fifty percent of a company's switching plant. Also, the loss of one or two large customers to bypass could represent the loss of 40 to 60 percent of the company's revenue base.

Such changes are likely to require small companies using price cap regulation to have to request rates above the established cap. The standards set forth in the FCC proposal for justifying above-cap rates are quite demanding and could be devastating for small companies. The commission should permit less onerous cost support for small companies filing price cap tariffs. Perhaps the simplified tariff filing rules adopted in CC Docket No. 86-467 could be applied to price cap tariffs as well.

Making these adjustments in the ongoing operation of the price cap plan would make such a regulatory alternative more workable for small carriers.

Obviously, the FCC's price cap proposal needs significant changes to be beneficial for small companies. While representatives of the FCC have assured OPASTCO and others that the needs of small companies will be met, the documentation thus far fails to support that commitment. OPASTCO strongly believes that any price cap program adopted by the FCC must include provisions that not only make such a plan a realistic and viable alternative for small companies, but which also protect those companies electing to remain with rate of return regulation.

MURPHY & MALONE,
Washington, DC, August 2, 1988.

Hon. DANIEL K. INOUYE,
Chairman, Subcommittee on Communications, Committee on Commerce, Science and Transportation, U.S. Senate, Senate Hart Office Building, Washington, DC.

DEAR MR. CHAIRMAN: In today's hearing on the Federal Communications Commission's proposed price cap plan, you asked the second panel to comment on British Telecom's quality of service and efficiency under the United Kingdom's price cap plan.

Because Ms. Gail Garfield Schwartz, Deputy Chairman of the New York State Public Service Commission, made several unclear statements to the Subcommittee, we request that you place in the hearing record British Telecom's Comments, Reply Comments and Further Comments filed with FCC in the *Price Cap* proceeding (Docket No. 87-313).

These comments describe in detail the U.K. price cap system, and the July 26 Further Comments definitively refute any suggestion of a link between price cap regulation and recent service quality concerns in the United Kingdom.

As indicated in British Telecom's Further Comments, on July 7, 1988 the U.K.'s Director General of Telecommunications (DGT) found that price cap method is "the preferable approach to regulation", and noted a "wide acceptance . . . of the benefits of price cap regulation" in comments submitted by the British public. (*See* British Telecom's Further Comments, page 2.)

The DGT, Professor Bryan Carsberg, announced that the price cap regime would be extended for four more years beyond the previously established deadline of July 31, 1989, while amending the current formula from "RPI-3" to "RPI-4 1/2". (*See* British Telecom's Further Comments, page 2.)

In response to your question concerning BT's quality of service and efficiency, Ms. Schwartz stated that, based on what acquaintances in Britain had told her, BT's quality of service was "terrible" and its service "was going down."

Professor Carsberg attributed 1987 service difficulties—in 1986, he stated, service was improving—to a large growth in demand imposed on a rapidly-modernizing system in a country experiencing a rise in business activity and with newly-deregulated financial markets; a lengthy strike; and an entirely unpredicted (and in Britain unprecedented) major hurricane that struck after midnight on October 16. The hurricane did widespread damage throughout South East England, and British Telecom lost approximately 20,000 telephone poles in an hour. Price cap regulation had nothing to do with this.

As explained in its July 26 Further Comments, British Telecom has announced, and is developing, an innovative contractual liability program to compensate its customers for delay in fault repair and in installation. No other telephone company does this. The Company has suggested that such a plan presents appropriate economic incentives for the maintenance of service quality.

But Professor Carsberg also stated in his 1987 Annual Report that:

". . . the key [to service quality] is in the modernization of the network. . . . BT now has one of the most ambitious plans of any operator in the world for converting its network to digital operation and it is also upgrading its transmission systems. It has accelerated these plans since privatization and under the spur of competition."

In the last year alone, BT has invested £2.4 billion to modernize its network and to bring into service another 721 digital exchanges (two per calendar day); a total of 1,474 digital exchanges now are in service. Six times as many BT customers are served by digital exchanges as a year ago, with five percent of all residential customers and 19 percent of business customers so connected. (*See* British Telecom's Further Comments, pages 7-8.)

We hope BT's attached Comments, Reply Comments and Further Comments will clarify the hearing record. We would welcome the opportunity to discuss these submissions with yourself and/or the Subcommittee's staff.

Respectfully yours,

TERENCE ROCHE MURPHY.

Enclosures.[1]

---

[1] The enclosures were not reproducible.

BELL ATLANTIC,
Arlington, VA, August 26, 1988.

Hon. DANIEL K. INOUYE,
Chairman, Communications Subcommittee, Committee on Commerce, Science and Transportation, U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: I am pleased to respond to your invitation of August 1 to provide additional comments regarding the Federal Communications Commission's price cap proposal. My enclosed response explains in more detail the benefits to consumers of price cap regulation and answers concerns regarding the quality of service under a price cap system.

Beyond these questions, I want to emphasize the importance I attach to improving the telecommunications policies of this country. As you are very much aware, the telecommunications infrastructure is a vital element in this nation's efforts to improve its ability to compete internationally. Other nations, most notably Japan and West Germany, have recognized that telecommunications can no longer be viewed as simply a local, domestic telephone matter. They are committed to substantial investment programs designed to ensure that their telecommunications systems are as up-to-date, efficient and effective as possible.

Incentive regulation embodied in the FCC's price cap proposal is an important means of ensuring that the privately financed and operated public telephone companies in this country have the incentives necessary to keep the telecommunications network as modern and efficient as possible. That is the challenge facing all of us and I know you have my concern that we successfully meet this challenge.

I wish to convey my willingness to work with you on your concerns and reach a resolution in a timely fashion so that the docket may proceed. I thank you for opportunity to share the enclosed comments and I would be pleased to respond to any further questions you may have.

Sincerely,

THOMAS E. BOLGER,
Chairman of the Board.

Enclosure.

RESPONSE TO COMMUNICATIONS SUBCOMMITTEE CONCERNS

Ratepayer benefits of price caps

One of the main benefits price caps offer for customers is lower rates. Under the plan now being considered, rates are guaranteed to decrease in real dollars over the next four years. The FCC price index would keep prices 3 percent below the general rate of inflation in the national economy. (If inflation is less than 3 percent, the formula requires absolute rate decreases.)

This 3 percent offset reflects an aggressive productivity commitment that is over 3 times greater than the productivity gain for the economy as a whole. Moreover, this productivity commitment is guaranteed to customers regardless of whether the telephone companies are able to achieve this ambitious productivity goal. No other sector of the economy offers customers this kind of guarantee.

Equally important, the productivity commitment will profoundly affect how carriers manage their business. It does this by creating strong incentives to ensure that they become more efficient in producing today's services and more innovative with new services in the future. Stated simply, the only way a carrier can make any money under price caps is to get more innovative, more creative, and more efficient in offering communications services which customers want to buy.

Effect of price caps on quality of service

Some have expressed concern that the pressure to be more efficient will lead carriers to cut corners on maintenance and investment and thus to let the quality of service deteriorate. This concern is unfounded.

First, Bell Atlantic simply cannot afford to let the quality of its service slip. We sell the vast majority of those interstate services which would be subject to price cap regulation to highly sophisticated communications firms like AT&T, MCI, and US Sprint. They would quickly notice any decline in quality and complain to the regulators. Under the plan now being considered, today's entire system of handling

complaints and monitoring quality and other aspects of our performance would remain in place.[1]

What makes us a lot more nervous than the prospect of complaints to the regulators, though, is the fact that our big customers will not tolerate lousy service because it will adversely affect the quality of their own services. Even if price cap regulation gave us an incentive to lower our quality—and, as discussed below, it does not—to do so would just cause our most important customers to bypass us in order to maintain the quality of their own services.

The ease with which interexchange carriers can bypass local telephone companies was illustrated recently as a result of the unfortunate fire which destroyed one of Illinois Bell's local switches outside of Chicago. Immediately following the fire, both MCI and AT&T moved quickly to install bypass facilities for their major customers in the area.[2] AT&T placed bypass facilities for twenty-five major customers; MCI did so for mix.[3] As noted in the Wall Street Journal, "by quickly acting to plug some of their stranded long-distance customers into substitute networks, the two communications giants induced some heavy users to consider permanently bypassing the connecting services of the local telephone company." [4] Letting the quality of our service slip simply makes no sense from a business perspective.

It should be emphasized, though, that fear of losing business is not the only, or even the strongest, reason that service quality under price caps will remain high. The fact is that—fortunately for all concerned—in telecommunications, efficiency is not in conflict with quality of service. Indeed, price cap regulation should actually help to improve quality because the cost-saving investments in modern switching and transmission facilities which price cap regulation encourages also let us provide better service.[5] Replacing older switching and transmission systems with modern digital switches, improved automated network control systems and fiber optic transmission paths all save us money by cutting maintenance costs. At the same time, though, they improve the quality of today's service by giving customers faster dial tone, clearer transmission, and more accurate and prompt connections.

But it does even further than that. Investment in modern, efficient technology also gives us the opportunity to provide modern services such as Speed Calling, Call Forwarding, and Call Waiting, which some older switches cannot provide, as well as information-age services such as so-called "CLASS" services [6] and the sophisticated capabilities of the Integrated Services Digital Network ("ISDN").[7]

Because price caps will stimulate investment in modern telecommunications technology, the whole nation benefits. A major challenge facing our country today is how to make our industries more effective in world markets increasingly dominated by foreign competitors from Japan and elsewhere along the Pacific Rim. One way to help America be more competitive is to make sure that our telecommunications infrastructure is as modern, efficient, and innovative as it can possibly be.[8] Price caps will give the industry the incentive to do just that, while at the same time giving consumers a guarantee of real price declines.

---

[1] In addition to the complaint process, today's wide range of financial and technical reporting requirements to which telephone companies are now subject would be retained. The accounting separations rules developed in Docket No. 86-111 and the "open network architecture" requirements of the *Computer III* inquiry will also remain in effect. *See* Further Notice of Proposed Rulemaking, In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, CC Dkt. No. 87-313, ¶¶ 196-97, 491, 495 (May 23, 1988). Moreover, programs such as "Link-Up America" and "Lifeline," designed to ensure that needy families and individuals are not deprived of telephone service, will also remain in force during the price cap trial. *Id.*, ¶ 179.

[2] "MCI, AT&T Acted To Plug In Business Of Midwest Clients," *Wall Street Journal*, June 6, 1988, p. 26.

[3] *Id. See also Computerworld*, May 23, 1988, p. 101 (MCI set up bypass systems for Dun & Bradstreet Corp., Prime Computer, Inc., the Hartford Insurance Group, Nalco Chemical Co., and Bekins Van Lines).

[4] "MCI, AT&T Acted To Plug In Business Of Midwest Clients," *Wall Street Journal*, June 6, 1988, p. 26. *See* also, "Users Look To Bypass Nets in Wake of Ill. Bell Blaze," *Network World*, June 20, 1988.

[5] This has been recognized in Great Britain where price cap regulation has been in effect for several years. Professor Carsberg, in his 1987 Report (Report of the Director of Telecommunications, May, 1988, p. 2), stated that the key to service quality is in the modernization of the network.

[6] CLASS services permit the called party to block specified incoming calls and to determine the calling telephone number prior to answering the telephone.

[7] For example, ISDN-equipped lines can transmit both voice and data simultaneously, a feature likely to be especially useful for the millions of residence and business customers who use personal computers to transmit information to and from each other and to access various commercial data bases.

[8] The Japanese understand this quite well and are pouring billions into improving their telecommunications network.